afme/ Finance for Europe

Association for Financial Markets in Europe

Appendix A - AFME detailed response to Consultation on the renewed sustainable finance strategy

15 July 2020

SECTION I: QUESTIONS ADDRESSED TO ALL STAKEHOLDERS ON HOW THE FINANCIAL SECTOR AND THE ECONOMY CAN BECOME MORE SUSTAINABLE
Question 1: With the increased ambition of the European Green Deal and the urgency with which we need to act to tackle the climate and environmental-related challenges, do you think that (please select one of the following): • Major additional policy actions are needed to accelerate the systematic sustainability transition of the EU financial sector. • **Incremental additional actions may be needed in targeted areas, but existing actions implemented under the Action Plan on Financing Sustainable Growth are largely sufficient.** • No further policy action is needed for the time being.
Additional comment: There are certain challenges in answering this question. On the one hand we acknowledge that in the future some further policy changes might be needed to help the financial sector to transition to sustainable business models. However, we think that policies that have already been adopted or are planned to be adopted in the next few years (e.g. on sustainable corporate governance, due diligence though supply chains, etc.) are largely sufficient. Appropriate time should be allowed for financial market participants to implement the new measures, as well as for the European Commission to carry out an ex-post Impact Assessment of the Regulations. We strongly believe that the focus of policymakers should now be on establishing clear transition pathways for the real economy sector, enabling it to transform its business models. Financial markets policy should not be seen as a substitute for other policy measures relating to environment, climate, or social issues.
Question 4: Would you consider it useful if corporates and financial institutions were required to communicate if and explain how their business strategies and targets contribute to reaching the goals of the Paris Agreement? • Yes, corporates; • Yes, financial institutions; • **Yes, both;** • If no, what other steps should be taken instead to accelerate the adoption by corporates and financial sector firms of business targets, strategies and practices that aim to align their emissions and activities with the goals of the Paris Agreement? [BOX, 2000 characters] • Do not know.
Additional comment: We recommend a phased disclosure approach, whereby corporates start first by disclosing **more granular** and **globally consistent information** about their path to Paris Agreement

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alignment. This data will then help financial institutions to assess the extent to which they might be able to define objectives for alignment of lending portfolios and measure against those objectives.

We note that the ability of banks to fully integrate ESG into their lending practices and make their balance sheets more sustainable will to a large degree depend on their clients' ability to achieve their sustainability goals/transition towards reaching their climate goals.

We also note that the Paris Agreement objectives remain the main reference point globally. Aligning business strategy with the Paris Agreement targets is also consistent with the commitments which many financial institutions have taken (e.g. Principles for Responsible Banking).

Question 5: One of the objectives of the European Commission's 2018 Action Plan on Financing Sustainable Growth is to encourage investors to finance sustainable activities and projects. Do you believe the EU should also take further action to:

- Encourage investors to engage, including making use of their voting rights, with companies conducting environmentally harmful activities that are not in line with environmental objectives and the EU-wide trajectory for greenhouse gas emission reductions, as part of the European Climate Law, with a view to encouraging these companies to adopt more sustainable business models: scale from 1 (strongly disagree) to 5 (strongly agree).

  AFME response: 4

- Discourage investors from financing environmentally harmful activities that are not in line with environmental objectives and the EU-wide trajectory for greenhouse gas emission reductions, as part of the European Climate Law: scale from 1 (strongly disagree) to 5 (strongly agree).

  AFME response: 3

- In case you agree or strongly agree with one or both options [4-5]: what should the EU do to reach this objective? [BOX, 2000 characters]

We believe there should be a positive approach rather than a penalising approach. While it is not quite clear what is meant by "discouraging investors", the current reality is that the majority of the economy is at a stage where a transition to low carbon business models is needed. Penalising investments in environmentally harmful activities may be detrimental to companies that are **on a transition path** but still have to carry out these activities today. Companies need access to capital to operationalise that transition. Policy intervention to discourage financing companies operating in high emitting sectors in Europe might also lead to a shift to other funding sources, such as self-funding or third-country investors.

SECTION II: QUESTIONS TARGETED AT EXPERTS

Question 6: What do you see as the three main challenges and three main opportunities for mainstreaming sustainability in the financial sector over the coming 10 years?

- [BOX, 2000 characters].

Key opportunities for mainstreaming sustainability in the financial sector:

1. The EU's COVID-19 recovery measures can also be utilised to support the necessary reforms of the European economy to achieve long-term climate neutrality, reconciling the measures under the European Green Deal with the recovery plan and utilising measures such as the Just

Transition Fund. For example, the experience of the auto industry after the 2008 financial crisis is a good illustration of what could be achieved through COVID-19 recovery plans. The requirement for US auto manufacturers to direct bailout funds towards investments in electric vehicles helped to speed up the industry's transition which is now well under way. Generally, clearly laid out policies and commitments from governments to longer-term infrastructure plans and programmes can help to reduce project risk and at the same time steer the private sector to support sustainable projects.

2. Clarifying roadmaps for the transition of primary sectors will allow for acceleration of financial flows to support transitions and potentially reduce the need for regulation of the financial sector that would only indirectly support the change.

3. Digital transition, which is ongoing and likely to further accelerate, should also lead to the development and implementation of technological solutions to resolve data issues in tracking and reporting on sustainability risks and factors. Enhanced reporting would provide improved information for end users, informing a trend in sustainability-linked consumer/investor choice and responding to growing consumer consciousness and demand for sustainable products.

Key challenges for mainstreaming sustainability in the financial sector:

1. The current framework on sustainable finance is complex to navigate (see also our response to Question 7) . Obligations on the financial services sector are increasing significantly, allowing only for a limited time to fully evaluate the impact of new rules and implement the necessary changes. Such a fast moving environment can lead to a skills gap and to pressures on resources to meet the requirements.

2. Availability of reliable data on sustainability to aid investment decisions: key challenges relate to (i) a lack of standardisation and common metrics across the ESG ecosystem; (ii) insufficient disclosure by non-financial corporations caused by the lack of harmonised reporting standards; and (iii) inconsistent methodologies used by ESG rating agencies. Forward looking data can also pose a challenge since it will depend to some extent on modelling techniques which may differ across sectors/companies.

3. International coordination:

    - A lack of internationally harmonised standards given the interconnectedness of capital markets. We encourage the EU, for example through the International Platform on Sustainable Finance (IPSF), to coordinate its work with IOSCO and its Sustainability Task Force (STF) to tackle the most critical issues such as those noted in the recent IOSCO report[1]:

        a) Multiple and diverse sustainability frameworks and standards;
        b) Lack of common definitions of sustainable activities; and
        c) Greenwashing and other investor protection challenges.

[1] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD652.pdf

- A challenging international environment for the EU, forcing unilateral action. Given that climate change is a global challenge, a global response and international buy-in is needed, given competitive implications for the financial sector and broader economy when dealing with the transitioning assets (as noted in our response to Question 5);

- EU taxonomy: the EU taxonomy is an important step but is not yet globally accepted by third country regulators or investors who may have different preferences/horizons for transition. There are concerns about potential implications for the assets already held which would no longer be considered sustainable under the Taxonomy as well as whether the narrow band of assets that currently qualify as sustainable will remain so when the EU reviews its criteria over the next few years. This is of particular concern to European investment firms, who may be cautious about offering sustainable funds to retail investors that contain assets that maybe considered sustainable when offered, but which may cease to be sustainable if the criteria are changed. We also note the assessment of 'do no significant harm' (DNSH) criteria for some sectors (e.g. nuclear power) will not be completed before the publication of the delegated acts (DAs) related to climate mitigation and adaptation (per the recent mandate to the Commission's Joint Research Centre), which risks creating investment uncertainty in relation to those sectors. AFME would support the development of a harmonised taxonomy, agreed at international level (or mutually recognised taxonomies – acknowledging that a single taxonomy might not be achievable due to the specificities of different regions/countries).

Please refer to additional comments relevant to securitisation transactions in a separate paper **AFME response to EC on Renewed Susainable Finance (Green Securitisation) 15 July 2020**.

Question 7: Overall, can you identify specific obstacles in current EU policies and regulations that hinder the development of sustainable finance and the integration and management of climate, environmental and social risks into financial decision-making?

- Please provide a maximum of three examples [BOX max. 2000 characters].

1. **The current framework on sustainable finance is complex to navigate:** New sustainability related obligations for the financial services sector are increasing significantly within the EU, allowing for a limited time to assess the implications of new rules and implement changes. Implementation timelines of inter-dependent policies often lack coherence and are very difficult to meet with e.g. level 2 measures not being adopted and in place before the entry into effect of the level 1 framework exposing firms to unnecessary double implementation costs (e.g. Low Carbon Benchmark Regulation). Additionally, firms may not have sufficient resources, including data and skills to meet these requirements, especially in the absence of appropriate implementation time being provided. These issues risk diverting attention from developing a sustainable suite of products for businesses and retail.

2. **European Green Deal (EGD) and international coordination:** Streamlining of priorities is needed within the proposed industrial strategy, so the financial sector can better identify opportunities ahead. There is a lack of clarity on how each sector should transition. This should be done in cooperation, as much as possible, with other jurisdictions.

3. Definitions, taxonomies and reporting need harmonisation:

- Definitions: There is a need to simplify and align the sustainable finance terminology (e.g. there are already initiatives to achieve this, such as ICMA's work[2] & IIF's work[3] on a common language of sustainability). Specifically, further work should be done to clearly articulate what it means to count as sustainable for economic activities (i.e. as per Taxonomy), for sustainable products (i.e. Green Bonds / Loans, Investment Products) and for a company (i.e. ESG ratings).

- Taxonomies:
  - *Investment purposes:*
    - EU Taxonomy adopted is based on NACE classification system, and some sub-activities do have an assigned NACE code
    - Huge expertise required to analyse and understand the technical criteria (thresholds) per activity within the tight implementation timelines
    - It is unclear how Taxonomy will evolve going forward
    - There is a significant ESG data gap (focus has been on financial institutions when it is corporates who need to provide data in the first instance; there is a timing mismatch among various reporting requirements – see point 1 above)
    - EU Taxonomy is very helpful but the usability of this tool is still complex. In particular, it is unclear how to use the taxonomy for general purpose lending/investment, which is company based and not economic activity based (and most of the funding in the market is fungible);

  - *Risk management purposes:* there is a need for common taxonomies to be used for climate/ESG risk management to assess the level of risk for different asset classes. Such a common taxonomy should underpin the harmonisation of risk management methodologies, data sources and scenarios to produce comparable results and reporting on ESG risks. Such taxonomy would not be the same as the one designed for investment purposes referred to above, as asset environmental performance might not be indicative of the level of environmental/ESG risk that the asset is subject to (e.g. a wind farm in the area with higher physical risks).

- Reporting: There is a need to establish common ESG/Sustainability reporting standards internationally. We welcome the Commission's initiative to revise the existing Non-Financial Reporting Directive (NFRD) with a view to develop coherent EU-wide reporting standards taking into account best practices from the available global frameworks. For a detailed AFME position on this issue (also endorsed by ISDA), please refer to AFME Response to consultation on the revision of NFRD[4].

Question 8: The transition towards a climate neutral economy might have socio- economic impacts, arising either from economic restructuring related to industrial decarbonisation, because of increased climate change-related effects, or a combination thereof. For instance, persons in vulnerable situations or at risk of social exclusion and in need of access to essential services including water, sanitation, energy or transport, may be particularly affected, as well as workers in sectors that are particularly affected by

[2] https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/Sustainable-Finance-High-Level-Definitions-May-2020-110520v4.pdf
[3] https://www.iif.com/Press/View/ID/3637/IIF-Proposes-Alignment-Around-Fewer-Simpler-Sustainable-Investment-Terms-to-Enhance-Transparency-and-Bolster-Confidence-in-the-Integrity-of-the-Market
[4] https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20ISDA%20NFRD%20revision%20consultation%20response_Final_11062020.pdf

the decarbonisation agenda. How could the EU ensure that the financial tools developed to increase sustainable investment flows and manage climate and environmental risks have, to the extent possible, no or limited negative socio-economic impacts?

- [BOX, 2000 characters]

The EU and member states have a number of public policy tools available to drive sustainable investment, such as taxes, subsidies, state aid mechanisms, regulation and others. We believe that these tools play an important role in the EU's sustainable finance agenda to enable the transition to a carbon neutral economy by 2050.

We would encourage the European Commission to carefully assess the impact of any tools already used to incentivise sustainable investments and whether there are best practices that can be implemented across the EU more widely.

AFME would be opposed to any penalising policy action directed towards financial institutions that invest in/lend to high carbon emitting sectors **that are in their journey to transition**, for a number of reasons:

1. These sectors need to transform but this cannot happen immediately without causing potentially severe social implications, such as increased unemployment. Penalising European banks for providing funding for these sectors could also reduce lending that obstructs the journey to transition.
2. The EU, as well as governments globally, needs to find the right balance between the ambition to transition to a carbon neutral economy by 2050, and the capacity of the economy to undertake this transformation.

It is important for banks, but also other stakeholders in society, to continue to support all economic sectors in their transitional path. The European Just Transition Fund will be instrumental in achieving this, and therefore the territorial transition plans have to be carefully designed. Consideration should be given to how incentives could contribute to transition funding, for example well-designed market-based carbon pricing mechanisms, risk sharing mechanisms such as guarantee funds especially for SMEs, or tax subsidies to either (or both) issuers/borrowers and investors/lenders. It is also key to ensure dialogue among stakeholders, including citizens, businesses, and civil society, to reach a common vision on how to approach the transition.

Question 9: As a corporate or a financial institution, how important is it for you that policy-makers create a predictable and well-communicated policy framework that provides a clear EU-wide trajectory on greenhouse gas emission reductions, based on the climate objectives set out in the European Green Deal, including policy signals on the appropriate pace of phasing out certain assets that are likely to be stranded in the future?

- Please express your view by using a scale from 1 (not important at all) to 5 (very important).
- For scores of 4 to 5, what are, in your view, the mechanisms necessary to be put in place by policy-makers to best give the right signals to you as a corporate or a financial institution? [BOX, 2000 characters]

5 - Very important

It is very important that policymakers define clear paths on how each sector of the economy will transform to meet the targets of the Paris Agreement. A predictable, coherent and well-communicated framework focused on transition pathways should clearly set out policies and incentives to enable financial institutions to support companies of all sizes in their sustainability transition. Moreover, to correct the mismatch between the available sustainable projects and the pool of capital available to invest based on the risk, governments must reduce the risks and therefore the costs of capital on renewable assets. A clear policy framework would be pivotal to achieving this objective. While the Paris Agreement provides the targets and glide paths, investors need a clear policy framework built around trajectories towards those targets. Such a policy based on clear transition pathways would reassure investors and corporates that there is a tangible commitment and plan as to how to fulfil the stated transition ambition over the course of the glide path.

The EU Green Deal is a welcome blueprint on how Europe can transform into a fair and prosperous low carbon economy. To this point, policies targeting real economy sectors (such as recently released strategy documents by the EC on Circular Economy, Farm to Fork, and Biodiversity) should be prioritised and clearly articulated before introducing a new wave of regulation for financial services. We also believe that it is crucial to ensure that the post-COVID recovery plan integrates the priorities of the Green Deal, thus contributing to growth and jobs creation across Europe.

Question 10: Should institutional investors and credit institutions be required to estimate and disclose which temperature scenario their portfolios are financing (e.g. 2°C, 3°C, 4°C), in comparison with the goals of the Paris Agreement, and on the basis of a common EU-wide methodology?

- Yes, institutional investors
- Yes, credit institutions
- Yes, both
- No
- **Do not know**

Additional comment: Financial institutions can only be required to do it after they are able to source the respective relevant and reliable information from their investees/borrowers as well as once methodologies available on the market have been refined and have matured.

Question 11: Corporates, investors, and financial institutions are becoming increasingly aware of the correlation between biodiversity loss and climate change and the negative impacts of biodiversity loss in particular on corporates who are dependent on ecosystem services, such as in sectors like agriculture, extractives, fisheries, forestry and construction. The importance of biodiversity and ecosystem services is already acknowledged in the EU Taxonomy. However, in light of the growing negative impact of biodiversity loss on companies' profitability and long-term prospects, as well as its strong connection with climate change, do you think the EU's sustainable finance agenda should better reflect growing importance of biodiversity loss?

- **Yes**/No/Do not know
- If yes, please specify potential actions the EU could take. [BOX max. 2000 characters]

We believe that the sustainable finance agenda should reflect the growing importance of preserving biodiversity. However we do not believe that it is necessary to go beyond the taxonomy for the moment, to ensure full implementation of the number of upcoming regulatory changes in the legislative pipeline. It is important that the transition to sustainable finance is done in an orderly and efficient manner. Before introducing any measures, it is important to define what a substantial contribution to biodiversity looks like and how the impact, both qualitative and quantitative, on biodiversity can be measured.

We stress that the tools and methodologies currently available for measuring, disclosing and managing biodiversity risks are still in their infancy. A recent study[5] carried out by the Dutch National Bank concluded that the limited availability of data hindered its ability to fully assess biodiversity risk. The report also acknowledged the need to further develop consistent and widely applied standards for measuring and disclosing biodiversity risks.

At the same time, we believe it would be necessary to facilitate companies' transparency around risk exposure / assessments associated with biodiversity loss and actions to mitigate such risks; as well as increase companies' responsibilities around biodiversity in the supply chain (including outside the EU).

Question 12: In your opinion, how can the Commission best ensure that the sustainable finance agenda is appropriately governed over the long term at the EU level in order to cover the private and public funding side, measure financial flows towards sustainable investments and gauge the EU's progress towards its commitments under the European Green Deal and Green Deal Investment Plan?

- [BOX, 2000 characters]

Effective governance of the sustainable finance agenda is key to achieving the sustainability transition. Because so many sectors of the European economy are directly or indirectly involved in this project, it is crucial to define the right transition paths for all sectors involved. Equally, it will be important for the European Commission to coordinate all initiatives across different DG's to ensure that a coherent policy framework is in place with clear long-term goals.

It would also be helpful to embed EU Green Governance in the EU Multiannual Financial Framework to ensure accountability and predictability on the public funding side over a long-term horizon. Furthermore, we consider that the EU Platform on Sustainable Finance (PSF) will play a central role in involving the private funding side. We also urge the European Commission and policymakers to ensure effective stakeholder engagement through industry dialogue and consultation, particularly on upcoming regulatory initiatives and reviews.

It could also be helpful to track how much of the identified investment required to reach the aims of the EU Green Deal have been mobilised. For example, this could be achieved through introducing indicators as part of the development of the CMU.

Furthermore, the creation of a centralised electronic register for ESG data in the EU would help support the sustainability agenda.

Question 13: In your opinion, which, if any, further actions would you like to see at international, EU, or Member State level to enable the financing of the sustainability transition? Please identify actions aside from the areas for future work identified in the targeted questions below (remainder of Section II), as well as the existing actions implemented as part of the European Commission's 2018 Action Plan on Financing Sustainable Growth.

- [BOX, 2000 characters]

Further action should focus on:

- promoting international coordination and alignment of rules and practices around sustainable finance (also see answer to Question 76); and

[5] https://www.dnb.nl/en/news/news-and-archive/dnbulletin-2020/dnb389169.jsp

- increasing market liquidity of sustainable financial products through reducing market fragmentation and market access issues.

Jurisdictional arbitrage and market fragmentation could severely undermine the efforts made by the public and private sector. It is also important to incentivise third countries to adopt shared sustainability policies, for example, through providing information and training on issues related to sustainability, environmental protection and social justice.

AFME welcomes the launch of the recent International Platform on Sustainable Finance (IPSF) by the European Union and institutions from other countries together with the International Monetary Fund (IMF). This is a clear step forward and a good example of coordinated and appropriate international cooperation that will cover capital market initiatives and encourage sustainable investment globally.

We further think that EU policymakers should closely engage with the official international standard setters, such as IOSCO and BCBS, to promote consistency around future policy on sustainable finance.

Finally, the current pandemic and economic crisis have reinforced the need for a comprehensive and global approach to cope with the heightened asymmetries, weaknesses and inequalities of our system that must be properly considered to achieve sustainable, inclusive and fair development. Recovery should come with conditions targeting an inclusive and sustainable economy, thus mutual support and coordination are essential.

1. STRENGTHENING THE FOUNDATIONS FOR SUSTAINABLE FINANCE

1.1 COMPANY REPORTING AND TRANSPARENCY

Question 14: In your opinion, should the EU take action to support the development of a common, publicly accessible, free-of-cost environmental data space for companies' ESG information, including data reported under the NFRD and other relevant ESG data?

- **Yes**/No/Do not know.
- If yes, please explain how it should be structured and what type of ESG information should feature therein. [BOX, 2000 characters]

The EU should support the development of a common, publicly accessible, affordable data space for ESG data that could be used to facilitate the compliance of financial institutions with regulatory requirements around ESG by providing access to relevant and reliable data at the EU level (ideally in a standardised form to enable artificial intelligence and machine learning models as well as providing access to disaggregated raw data). This database should include information required by ESG investors, analysts and rating agencies. The data in such a data space should be aligned with various indicators necessary to comply with forthcoming reporting requirements such as under the EU Non-Financial Reporting Directive (NFRD), the EU Taxonomy, Disclosure and Low Carbon benchmark regulations. Additionally, in order for this data to be globally comparable in the future, the data published should remain closely aligned with globally agreed disclosure principles (e.g. TCFD).

Please refer to additional comments relevant to securitisation transactions in a separate paper **AFME response to EC on Renewed Sustainable Finance (Green Securitisation) 15 July 2020**.

1.2 ACCOUNTING STANDARDS AND RULES

Question 16: Do you see any further areas in existing financial accounting rules (based on the IFRS framework) which may hamper the adequate and timely recognition and consistent measurement of climate and environmental risks?

- Yes/no/do not know.
- If yes, what is in your view the most important area (please provide details, if necessary):
  - Impairment and depreciation rules. [BOX, 2000 characters]
  - Provision rules. [BOX, 2000 characters]
  - Contingent liabilities. [BOX, 2000 characters]
  - Other, please specify. [BOX, 2000 characters]

Developing models and approaches to measurement of financial risks arising from climate change or environmental degradation are still at an early stage of their development. At the current stage we think that the IFRS framework is fit for purpose and does not present issues that might hamper the adequate and timely recognition and consistent measurement of climate related and environmental risks. IFRS provides a sufficient framework for making materiality judgements and a number of other reporting considerations that can be relevant when dealing with these types of risk. A recent briefing note[6] from the IASB board member usefully highlights how the IFRS can be applied.

Nevertheless, we acknowledge that with further developments on the climate change front, there might be a need to reflect on whether any amendments to IFRS might be necessary, recognising that the evolution of accounting standards is a dynamic process. To this point we would like to highlight another matter that does not relate to climate risks specifically but rather to potential challenges around the accounting treatment of some emerging types of financial products, such as sustainability linked loans or bonds. We note that industries recognise the important role of these products in financing the transition to a net zero carbon economy in line with objectives with the European Green Deal. We note that recently several financial industry bodies have produced guidance on the issuance of sustainability-linked bonds[7] and loans[8], which is expected to result in increased volumes of this type of financing. A typical feature of these products would be linking the interest rate to the sustainability performance of the issuer/borrower as measured by pre-defined metrics and targets. IFRS 9 *Financial Instruments* sets the rules on the classification and measurement of financial instruments and requires financial assets (FAs) to be classified into the following categories:

Amortised cost: The asset is measured at the amount recognised at initial recognition minus principal repayments, plus or minus the cumulative amortisation of any difference between that initial amount and the maturity amount, and any loss allowance.
Fair value through other comprehensive income (FVOCI): The asset is measured at fair value with changes in fair value recognised in other comprehensive income.
Fair value through profit and loss (FVPL): The asset is measured at fair value. Changes in fair value are recognised in profit and loss as they arise.

Classification of financial assets is based on two pillars: **assessment of the business model** under which the assets are held and the results of so called "solely payments of principal and interest" **(SPPI) test**. The majority of banking "standard" loan portfolios meet the criteria of measurement at amortised cost which requires passing the SPPI test. This test requires that the contractual cash flows of an asset (e.g. loan) give rise to payments on specified dates that are **solely payments of principal** and **interest on the principal amount outstanding**. For this purpose, interest consists of consideration for the **time value of money**, for the **credit risk** associated with the principal amount outstanding during a particular period of time and for **other basic lending risks and costs** (e.g. liquidity and administrative costs associated with holding the asset for a particular period of time), as well as **a profit margin**. For example, a loan with interest payments linked to the EBITDA or revenue of the borrower would fail the

[6] https://www.ifrs.org/news-and-events/2019/11/nick-anderson-ifrs-standards-and-climate-related-disclosures/
[7] https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/June-2020/Sustainability-Linked-Bond-PrinciplesJune-2020-100620.pdf
[8] https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/LMASustainabilityLinkedLoanPrinciples-270919.pdf

SPPI test because these features introduce exposures to equity like risks (and not only credit risk or other basic lending risks). In respect of sustainability-linked loans it is not clear whether sustainability performance targets, which the interest rate is linked to, would go beyond the scope of a basic lending arrangement resulting in failing the SPPI test (and ultimately causing the loan to be measured at fair value). We note that measurement of financial assets at fair value may trigger additional regulatory capital considerations. If this would be the case of sustainability-linked assets, banks might be indirectly discouraged from mainstreaming this type of lending. We note that when IFRS 9 was being developed, sustainability-linked financing was practically non-existent and might not have been considered in depth from an accounting treatment perspective. We would thus like to draw the Commission's attention to this issue which might become material soon as the volume of such instruments will need to grow.

1.3 SUSTAINABILITY RESEARCH AND RATINGS

Question 17: Do you have concerns on the level of concentration in the market for ESG ratings and data?

- Please express your view by using a scale of 1 (not concerned at all) to 5 (very concerned).
- If necessary, please explain the reasons for your answer. [BOX, 2000 characters]

3 - Neutral

AFME believes that while there is some level of concentration in the market for ESG ratings and data which could impact the cost of data and its redistribution, there is increasing competition among ESG data providers with some well-established providers and the entry of major mainstream financial players into the market over the last years, such as MSCI, ISS, S&P and others. This will help to increase the quality of ESG data and services, for example, with:

- investors questioning rating providers about their methodologies;
- mainstream players enhancing their resource base; and
- external assurance providers being able to opine on the consistent application methodologies.

Concerns from the industry relate not so much to competitiveness but rather to the way that information is required under various regulatory obligations. At this stage, there are discrepancies in data/ratings provided by various ESG data/rating companies when it comes to the same issuers. This does not allow the data/ratings users (e.g. financial product manufacturers) to fully rely on such data. If the users were to rely on the data/ratings, there would need to be some verification/regulation process established in the future to ensure reliability of the data/ratings. However, we appreciate it might be premature at this stage to introduce such regulation (see our answer to Question 21).

Question 18: How would you rate the comparability, quality and reliability of ESG **data** from sustainability providers currently available in the market?

- Please express your view by using a scale of 1 (very poor) to 5 (very good).
- If necessary, please explain the reasons for your answer. [BOX, 2000 characters]

2 – Poor

Depending on the methodology, there are different points of emphasis about the impact on society/environment or about financial impact. Different areas of focus and different definitions of materiality and sustainability can lead to very different conclusions/ratings for any given company.

In principle, variety may be positive, as firms can choose the approach most relevant to them. However, at present, quality, reliability and verifiability of ESG data can vary between providers, depending on the robustness of the research methodology applied. Furthermore, ESG data is fragmented and collecting high-quality and comprehensive ESG data can remain a challenge as providers focus on different factors which can lead to low comparability. The industry might therefore benefit from some degree of standardisation and improvement in data collection and quality, whilst still ensuring helpful variety.

Moreover, as stated in the joint ISDA and AFME response to the European Commission's consultations on the three draft Delegated Acts (DAs), for the purpose of specifying requirements under the Low Carbon Benchmarks Regulation, the costs associated with the purchase of the full ESG data by benchmark administrators would discourage them from doing so. This could lead to a monopolistic situation where significant ESG benchmark administrators, who are also data providers, would be able to afford this additional reporting while medium and small administrators may have to indicate that their benchmark does not pursue ESG objectives (i.e. even where they include ESG filters). If such a monopolistic situation occurs, this could lead to raising costs for (i) ESG products suppliers (funds, insurers, etc), as many of those ESG products rely on ESG benchmarks, and (ii) for end investors.

The main concern relates to the issue of availability and quality of ESG data reported by companies in the real economy, which leads to significant disclosure gaps and major comparability, quality and reliability issues with regard to ESG data. A number of overlapping standards for disclosure (e.g. GRI, SASB, TCFD, EU NFRD) follow different methodologies and lead to diverging types of information being disclosed. Increased harmonisation should be fostered in coordination with preparers, users and assurance providers. For a detailed AFME position on this matter, also endorsed by ISDA, please refer to AFME's Response to consultation on the revision of NFRD[9]. We also welcome that the Commission has officially mandated[10] the European Financial Reporting Advisory Group (EFRAG) to start preparatory work on an EU non-financial reporting standard by early 2021 as one of the possible ways to increase relevance, comparability and reliability of non-financial information under the forthcoming NFRD review. For the time being, in the absence of a globally harmonised approach to ESG disclosure, there should be some tolerance for variations in assessments. It should also be acceptable that data from one provider may complement or add to that of another.

Finally, it would be very useful to standardise non-financial reporting in a way that allows company-specific information to be easily loaded into the research systems of interested financial market participants (e.g. through common standard reporting, common interfaces, etc.) so that they can have access to this information without having to go through ESG data providers.

Question 19: How would you rate the quality and relevance of ESG **research** material currently available in the market?

- Please express your view by using a scale of 1 (very poor) to 5 (very good).
- If necessary, please explain the reasons for your answer. [BOX, 2000 characters]

3 – Neutral

[9] https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20ISDA%20NFRD%20revision%20consultation%20response_Final_11062020.pdf

[10] http://www.efrag.org/(X(1)S(axq0mqhswujsqbsg43zdhjrg))/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FSiteAssets%2FLetter%2520EVP%2520annexNFRD%2520%2520technical%2520mandate%25202020.pdf

Fundamental research on ESG issues has been taking place for 15+ years now, previously under SRI and impact banners, so the quality is generally good with larger providers well established and sell-side research houses building large ESG teams and products. As the offering of ESG products increases and the market becomes more mature, research material is likely to further improve in quality. The main industry wide issue is the 'black-box' methodologies on scoring and rating. The main concern is less about the quality of research but about the comparability of results from different research providers (also see our answer to Question 18).
Question 20: How would you assess the quality and relevance of ESG **ratings** for your investment decisions, both ratings of individual Environmental, Social or Governance factors and aggregated ones? • Individual: Please express your view by using a scale of 1 (very poor quality and relevance) to 5 (very good). • Aggregated: Please express your view by using a scale of 1 (very poor quality and relevance) to 5 (very good). • If necessary, please explain the reasons for your answer. [BOX, 2000 characters]
Individual: 3 – Neutral **Aggregated: 2 – Poor** There is value in both individual and aggregated ratings. Aggregate ratings are useful in identifying the "best" and the "worst" companies, whereas individual measures are needed where specific issues relating to a company requires closer inspection and to support assessment of those companies situated in the middle of the aggregate assessments. However, the market for ESG ratings and data is fragmented and does not allow an easy comparison, as methodologies used vary from one provider to the other and can result in different ratings by different agencies for the same company. ESG rating agencies also do not always enter into dialogue with the companies they rate, which sometimes results in factually incorrect analyses and misleading/incorrect conclusions. Further considerations with regard to ratings include: • Lack of clarity on what ESG ratings are measuring (ESG risk exposure / ESG management preparedness / level of disclosure / physical risk, etc.). • "E" and "G" ratings are sometimes of better quality than "S" ratings, potentially due to the level of coverage and quality of the data at origin (data disclosed directly by the company), as there is more standardised reporting on "E" and "G" factors than on "S". • Backward-looking perspective for most assessments and excessive focus on disclosure of ESG compliance rather than ESG strategic considerations such as willingness and capacity for company transition towards sustainable business models. • Ratings tend to cluster companies into sectors in a heterogeneous manner without providing a granular analysis of the sectors. This high-level sector approach implies that the materiality applied to a sector quite often does not correspond with what is relevant at individual company level. To this end it would be helpful to include a tag whereby the rating would explain whether the sector aggregation is automatic or has been manually allocated by an analyst.

- Lack of transparency in methodologies and review processes, including detailed public communication regarding any major changes to methodologies and associated likely impacts before they occur.
- Appropriate management of potential conflicts of interest should be further considered as some ESG rating providers provide services to the companies they rate.
- Focus on public companies and low coverage of private companies.
- Insufficient focus on the sustainability and impact of a company's full value chain.
- Limited reliance on important industry standards (SASB, GRI, UNDP, Global compact principles, NFRD, TCFD etc.) It should be more explicitly disclosed when they are aligned to the standards and where not.
- Low ratio of ESG analysts / rated companies (especially compared to credit rating agencies)

Also see our answer to question 18.

Question 21: In your opinion, should the EU take action in this area?

- **Yes**/No/Do not know.
- If yes, please explain why and what kind of action you consider would address the identified problems. In particular, do you think the EU should consider regulatory intervention? [BOX, 2000 characters]

Careful consideration should be given as to when and how to subject ESG ratings and data providers to regulation. Given the increasing importance of ESG data and analysis, it might be beneficial, at a future point, to recommend the introduction of some regulatory requirements, including registration and supervision for providers, similar to those for Credit Rating Agencies. Any requirements introduced must be effective and proportionate so the sector can continue to innovate and support the sustainability transition. Any future regulatory action needs to be coordinated at the global level and, given the concerns raised in our answers to questions 17-20, should specifically focus on transparency and disclosures.

Given that major concerns relate to the availability of data, regulatory measures should first ensure the development of minimum standards for transparency, data quality and assurance of information produced by non-financial companies. In connection with the review of the NFRD, a mandatory reporting framework should be developed with a minimum set of cross sectoral and sector-specific indicators that companies should disclose, with flexibility for companies to provide additional information as they deem relevant (for a detailed AFME position on this matter, endorsed by ISDA, please refer to AFME's Response to consultation on the revision of NFRD[11].

Some suggested measures and considerations that could be introduced for ESG ratings/data providers over time include:

1. Non-regulatory measures, e.g. guidelines or code of best practice for the ESG data/rating providers, that could enhance data comparability and transparency. Also, common

[11] https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20ISDA%20NFRD%20revision%20consultation%20response_Final_11062020.pdf

evaluation standards, whilst preserving different views and approaches to research, could improve the quality of data and ratings. For example, it would be important to ensure that the data comes directly from the source and is clearly labelled (tagged) in cases where alternative data (not company reported, e.g. government data bases, NGO materials) is used.

2. Ensuring that any measures would still allow space for smaller niche research/data providers, including NGOs, investor initiatives, semi-commercial operators, to complement the larger data /rating providers.
3. Ensuring that sell-side research providers, who are already regulated, are not discouraged from developing their own models, as such entities can provide competition.
4. Banks are required to have controls to manage conflict of interest. The same should be required of ESG data providers. When the same entities rate companies, provide proxy advice, rate funds and construct indices, potential conflicts of interest could arise, causing competition and market integrity issues.

1.4 DEFINITIONS, STANDARDS AND LABELS FOR SUSTAINABLE FINANCIAL ASSETS AND FINANCIAL PRODUCTS

EU Green Bond Standard

Question 22: The TEG has recommended that verifiers of EU Green Bonds (green bonds using the EU GBS) should be subject to an accreditation or authorisation and supervision regime. Do you agree that verifiers of EU Green Bonds should be subject to some form of accreditation or authorisation and supervision?

- **Yes, at European level**
- Yes, at a national level
- No
- Do not know
- If necessary, please explain the reasons for your answer [BOX 2000 characters]

While we agree in principle that having a form of accreditation, authorisation, and supervision of verifiers of EU Green Bonds would be beneficial, the premature introduction of substantial regulation may lead to market concentration in the number of verifiers. To this end, we would support allowing the market for verification service providers to develop and then introduce appropriate regulation following a 'stock-taking' exercise.

If accreditation, authorisation and supervision of verifiers of EU Green Bonds is introduced, the key principles thereof should include: independence, transparency of methodologies (including their analytical quality), the adoption of proportionate governance (including appropriate management of conflicts of interest) and global convergence. A regulatory regime for verifiers of EU Green Bonds should also recognise:

1. the dynamic nature of the market and need for innovation; and
2. the differences between ESG information and financial information.

In the longer term, the establishment of accreditation/authorisation and related supervision for EU GBS verifiers would allow addressing a broader investor mix, extending beyond already existing 'green investors', who would feel more confident about the sustainability features of investment opportunities and would thus be more willing to invest. Some level of accreditation/authorisation and related supervision would be necessary to ensure proper corporate governance and disclosure as well as adequate and competent resources in relation to the tasks performed by the verifiers. We note that the accreditation/supervisory regime for the verifiers should not result in significant costs for issuers of green bonds in the EU. A centralised approach in Europe would be advisable to ensure a level playing field and comparability. However, we note that issuers should also be able to select other (e.g. national level) verifiers in addition, if needed. This is because other industry specific verifiers may be able to bring additional expertise particularly with regard to some very specific industry / use of proceeds categories pertinent to specific jurisductions. Please refer to additional comments relevant to securitisation transactions in a separate paper **AFME response to EC on Renewed Susainable Finance (Green Securitisation) 15 July 2020**.
Question 23: Should any action the Commission takes on verifiers of EU Green Bonds be linked to any potential future action to regulate the market for third-party service providers on sustainability data, ratings and research? • Yes / No / **Do not know** • If necessary, please specify the reasons for your answer [BOX 2000 characters]
Quality and reliability of the data is critical for the development of an efficient market. There may be some logic in linking the regulation of the verifiers of EU Green Bonds with any regulatory regime for providers of sustainability data, ratings and research given the potential overlap between the two and to the extent the Commission expects many service providers will wish to provide both services. However, we do not consider that there needs to be a link between the two and we would expect the scope of the data, ratings and research to be much wider. Our comments in Question 22 regarding the risks of introducing regulation prematurely (or, in this case, standards that are too narrow) and the key principles that should form part of any regulatory regime that is introduced apply equally to this question. If the policy decision is not to regulate the market for third-party service providers on sustainability data, ratings and research, an alternative would be to have a framework setting out how sustainability data, ratings and research and third party service providers thereof should operate (including professional standards), for example, in terms of the type and format of data collected, to encourage certainty and consistency as to the quality, reliability, format and type of data available to the market, including for verification purposes by verifiers of EU Green Bonds.
Question 24: The EU GBS as recommended by the TEG is intended for any type of issuer: listed or non-listed, public or private, European or international. Do you envisage any issues for non- European issuers to follow the proposed standard by the TEG? • **Yes**/ No/ Do not know

- If necessary, please specify the reasons for your answer [BOX 2000 characters]

It is likely that not all criteria defined in the Taxonomy will be applicable or relevant in all countries due to differences in legislation, availability of data or geological site-specific factors. It would be beneficial to give guidance where and what level of tolerance for deviation would be acceptable.

We believe that non-European issuers might face issues in following the EU GBS, such as NACE codes that the Taxonomy is based on. Furthermore, many of the Taxonomy requirements rely on EU regulation, which might be difficult to non-EU issuers to comply with.

We further note that there are international Green Bond frameworks (CBI, ICMA GBP), which are well understood and have been widely accepted by market participants. Issuers outside of the EU are likely to continue using the international frameworks due to the fact that the EU GBS, though quite consistent with such frameworks, requires alignment of the use of proceeds with the EU Taxonomy which is more restrictive than the principles of the existing international green bond standards.

We therefore think that issuers should follow the EU GBS proposed by TEG on a voluntary basis only (e.g. but which would represent a "best in class" label).

Prospectus and green bonds

Question 25: In those cases where a prospectus has to be published, do you believe that requiring the disclosure of specific information on green bonds in the prospectus, which is a single binding document, would improve the consistency and comparability of information for such instruments and help fight greenwashing?

- Please express your view by using a scale of 1 (strongly disagree) to 5 (strongly agree)
- If necessary, please specify the reasons for your answer [BOX, 2000 characters]

2 – Disagree

The issuance of a Green Bond is already complemented by very specific information in dedicated documents: the Green Bond Framework and the Second Party Opinion. The base MTN or Stand Alone prospectus, as the case may be, includes key information on the Issuer and cover legal and technical aspects relating to any issuance, regardless the specific use of proceeds.

We think that a prospectus is the appropriate place to explain how and if any green labels (EU GBS, GBP, etc.) are used when green bonds are issued. However, whilst including some key information in the prospectus would be desirable to also increase visibility, procedures and frameworks about green assets are continuously being reviewed and updated according to best practices in the market. In addition to this, Green Bonds are very frequently issued out of prospectuses which are used for the issuance of a wide spectrum of bonds. Therefore, it is more appropriate for the issuers, for the regulators, and in the end, for the investors, that specific information about the use of proceed of Green issuances, with the exception of the specific risk factors, can be reviewed and updated outside of the scope of the prospectus regulation. Otherwise, prospectuses should have to be updated by means of a supplement every time an update or an amendment is needed within the green bonds related specific documentation such as the frameworks, third party opinions. On this basis, we think that flexibility can be provided by having a separate document that outlines issuers' strategies and approaches on green financing away from a prospectus, but which can be incorporated by reference in the prospectus.

Please refer to additional comments relevant to securitisation transactions in a separate paper **AFME response to EC on Renewed Sustainable Finance (Green Securitisation) 15 July 2020**.

Question 26: In those cases where a prospectus has to be published, to what extent do you agree with the following statement:

"Issuers that adopt the EU GBS should include a link to that standard in the prospectus instead of being subject to specific disclosure requirements on green bonds in the prospectus"

- Please express your view by using a scale of 1 (strongly disagree) to 5 (strongly agree)
- If necessary, please specify the reasons for your answer [BOX]

4 - Agree

Key information on "green aspects" should be included in the prospectus but it might not be feasible, as explained in our response to Question 25, to include all the comprehensive information. The commitment to follow the EU GBS would be best placed in the legal documentation Terms and Conditions. This includes a commitment to be transparent as defined in the EU GBS. However, as the EU GBS and particularly the Taxonomy are subject to change, it would be necessary to be clear about the timing of the label, to show the relevant terms at the time of issuance and verification.

Please refer to additional comments relevant to securitisation transactions in a separate paper **AFME response to EC on Renewed Sustainable Finance (Green Securitisation) 15 July 2020**.

Other standards and labels

Question 27: Do you currently market financial products that promote environmental characteristics or have environmental objectives?

- **Yes**/No/Do not know.
- If yes, once the EU Taxonomy is established,5 how likely is it that you would use the EU Taxonomy in your investment decisions (i.e. invest more in underlying assets that are partially or fully aligned with the EU Taxonomy)? Please use a scale of 1 (not likely at all) to 5 (very likely). Please specify if necessary [box, 2000 characters

3 – Neutral

AFME members are marketing a number of such products across a wide range of asset classes and have indicated that there are material gaps which are unlikely to be filled by the time the new EU Disclosure and EU Taxonomy regulations become applicable. These gaps would ideally be filled by market data providers; however this will likely take time. We believe that regulatory forbearance might be required by national competent authorities, similar to that provided on the provisions of the Low Carbon Benchmark Regulation, in relation to compliance with (at least) the EU Disclosure Regulation applicable from 10 March 2021.

It should also be noted that the scope of the taxonomy is currently limited and will only cover a small part of the investment universe. Therefore, while the fact that a given investment is taxonomy-compliant is likely to make it more attractive/sought-after, it will be difficult to build well-balanced products (i.e. products that avoid excessive concentration risk) with a significant share of taxonomy-compliant investments.

Question 28: In its final report, the High-Level Expert Group on Sustainable Finance recommended to establish a minimum standard for sustainably denominated investment funds (commonly referred to as ESG or SRI funds, despite having diverse methodologies), aimed at retail investors. What actions would you consider necessary to standardise investment funds that have broader sustainability denominations?

- No regulatory intervention is needed.
- **The Commission or the ESAs should issue guidance on minimum standards.**
- Regulatory intervention is needed to enshrine minimum standards in law.
- Regulatory intervention is needed to create a label.

Question 30: The market has recently seen the development of sustainability-linked bonds and loans, whose interest rates or returns are dependent on the company meeting pre-determined sustainability targets. This approach is different from regular green bonds, which have a green use-of-proceeds approach. Should the EU develop standards for these types of sustainability-linked bonds or loans?

- Please express your view by using a scale of 1 (strongly disagree) to 5 (strongly agree).
- If necessary, please explain. [BOX, 2000 characters]

3 – Neutral

The development of bonds and loans linked to certain sustainability targets can help the transition of the investee companies and the entire economy toward a sustainable economy. Sustainability-linked bonds/loans offer a valuable source of funding for companies who want to put a financial link to their sustainability goals. Establishing clear standards and guidance for such products can potentially help counter the risk of green washing allegations, facilitate the set-up of respective facilities, increase transparency and facilitate market access.

Moreover, the liquidity, price transparency and attractiveness of sustainability-linked products can be further enhanced through the use of derivative instruments. In particular, SDG-linked derivatives have only recently started being used as a tool for channelling capital towards companies focused on ESG issues. Sustainability-linked derivatives transfer the risk associated with an SDG investment in the form of sustainability-linked bonds (SLBs) and loans (SLLs), to a financial intermediary in exchange for a fixed, recurring payment. These are primarily cross-currency swaps used to hedge against the potential exchange rate volatility and interest rate risk of the investment. In addition, they include a dedicated incentive mechanism that is fully aligned with the sustainable performance indicators outlined in the product's financing solution. Sustainability-linked products that utilise derivatives can attract much-needed investment for research and the low-carbon transition given that such investments have long-term objectives and require a long-term orientation.

However, this is a relatively new product while the development of the Green Bonds Standard was based on years of market evolution and market practice driven by GBP. The sustainability-linked bonds and loans use an even wider universe of reference points than green investments. This universe is yet to be defined and there is no need to limit the development at this stage. The products are well suited for neutral (with activities not defined in the taxonomy) companies to demonstrate commitment and action in sustainability subjects. Any guidance should start by enforcing transparency on the methodology for measuring the target and its materiality in terms of the company's overall impact. Furthermore, transparency on basic DNSH assessment could be considered.

We therefore believe that development of any prescriptive standards is not necessary at this stage, as the market should further mature and the experience of the EU Green Bond Standard should be observed to determine the need or benefit of EU standards for sustainability linked bonds or loans. It should also be noted that industry practices are already developing (e.g. by ICMA and LMA). We also think that the use of the EU Taxonomy should not be mandated for this type of instrument (please see our response to Question 31).

We think, however, that progress made on meeting the targets should be audited by a third-party verifier on the basis of objective indicators that would be easy to understand by retail investors.

Please refer to additional comments relevant to securitisation transactions in a separate paper **AFME response to EC on Renewed Sustainable Finance (Green Securitisation) 15 July 2020**.

Question 31: Should such a potential standard for target-setting sustainability-linked bonds or loans make use of the EU Taxonomy as one of the key performance indicators?

- Please express your view by using a scale of 1 (strongly disagree) to 5 (strongly agree).
- If necessary, please explain. [BOX, 2000 characters]

2 – Disagree

As noted in Question 30, we do not think there is a merit in codifying a potential standard at this stage. However, if there is a proven need to develop such a standard in the future, we think that, though the Taxonomy would be useful for certain products, a sustainability linked loan in the form of a sustainable improvement loan should not be linked directly to it. The aim of sustainability linked loans is to support AFME members' clients in the transition to a more sustainable and low carbon business model. Since the EU Taxonomy is a binary tool, and doesn't cover all sustainable improvement areas, neither social or governance aspects, we believe that a potential standard should not be linked to the Taxonomy as default option.

Given it is unclear to what degree the Taxonomy will be accepted as a market standard and how quickly it will develop in the future, there should be another objective – easily understandable and verifiable KPIs.

Please refer to additional comments relevant to securitisation transactions in a separate paper **AFME response to EC on Renewed Sustainable Finance (Green Securitisation) 15 July 2020**.

Question 32: Several initiatives are currently ongoing in relation to energy-efficient mortgages and green loans more broadly. Should the EU develop standards or labels for these types of products?

- **Yes**/No/Do not know.
- If yes, please select all that apply:
  - a broad standard or label for sustainable mortgages and loans (including social and environmental considerations);
  - **a standard or label for green (environmental and climate) mortgages and loans;**
  - a narrow standard or label only for energy-efficient mortgages and loans for the renovation of a residential immovable property;
  - **other: please specify what type of standard or label on sustainability in the loan market**

you would like to see [BOX, 2000 characters]

From a banking point of view, voluntary EU labels for lending products (e.g. plain vanilla lending products, structured finance facilities, etc.) would be welcome. However, the definition of such labels should be directly linked to the objectives under the European Green Deal policies, such as promoting energy efficiency, enabling a better use of private finance, promoting a more efficient allocation of financial resources, etc. (i.e. technical features of such banking products should support the relevant policies' targets). It is also important to ensure that any standards/labels developed are to the benefits of clients and do not deter innovation and focus. While some cohesion/standardisation can be useful, too much prescription could hamper further focus and development (risking to result in a "label-chasing" by financial product manufacturers).

We recognise that at the initial stage some green lending can generate lower returns to provide a form of incentive to borrowers willing to transform to a sustainable businesses. With private market participants being willing to forego some of the financial return, we would welcome fiscal mechanisms, such as reduced taxation, for instance, or the introduction of subsidies to at least partially compensate the private sector for associated costs.

We note that the EU Taxonomy can be applied in developing labels for green loans on a voluntary basis. We also note that such standards/labels should not be too specific so that they cannot be universally applicable across the different countries of the EU, considering the fact that the mortgage market differs significantly among EU countries and as there are already national certifications of buildings done by national authorities. A further recommendation would be for the data from the national certificates to be made available to financial institutions, across the EU.

Please refer to additional comments relevant to securitisation transactions in a separate paper **AFME response to EC on Renewed Sustainable Finance (Green Securitisation) 15 July 2020**.

Question 33: The Climate Benchmarks Regulation creates two types of EU climate benchmarks - 'EU Climate Transition' and 'EU Paris-aligned' - aimed at investors with climate-conscious investment strategies. The regulation also requires the Commission to assess the feasibility of a broader 'ESG benchmark'. Should the EU take action to create an ESG benchmark?

- Yes/**No**/Do not know.
- If no, please explain the reasons for your answer, if necessary. [BOX, 2000 characters]
- If yes, please explain what the key elements of such a benchmark should be. [BOX max. 2000 characters]

Endorsing ISDA's response

ISDA is of the view that the creation of a broader 'ESG benchmark' would be premature at this stage given that the implementation of the two new optional designations of EU Climate Transition (CTB) and EU Paris-aligned Benchmarks (PAB) has been significantly delayed and the Level 2 measures for the new rules have not yet been published. This has resulted in ESMA publishing the first no action letter to provide temporary relief from the rules for benchmark providers and users. The proposed Level 2 rules on the ESG disclosure and Climate Benchmark methodologies currently envision quite disproportionate and prescriptive provisions.

The Low Carbon Benchmarks Regulation ("LCBR") is a good example of a well-intentioned part of the sustainable finance agenda becoming disproportionate to its goal and increasingly unmanageable. According to Article 54 of the LCBR, the EC is required to submit a report to the co-legislators on the impact of this Regulation and the feasibility of an "ESG benchmark", taking into account the evolving nature of sustainability indicators and the methods used to measure them, by 31 December 2022. However, before considering the development of such a benchmark, which would likely create additional administrative requirements and costs for benchmark administrators, it is important to take stock of the current state of play, phase-in of requirements, and implementation challenges in respect of CTB and PAB.

ESG benchmarks can include a broad variety of ESG factors or just one single factor (for example, only targeting carbon efficiency or a specific social component). While certain elements of ESG may be objectively measured (such as greenhouse gases) other matters are highly subjective (such as social convictions). LCBR allows benchmark administrators to have a certain degree of flexibility when designing benchmark methodologies and to create benchmarks that take into consideration additional ESG factors further to the carbon reduction objective. These are key provisions aiming at not stifling innovation and at supporting the uptake of the wider ESG index market. ISDA would therefore like to caution the EC against designing a new ESG benchmark through legislation before conducting a thorough analysis of how the CTB and PAB are used in the market.

Furthermore, the various sustainable finance policy initiatives cannot and should not be seen in isolation. A consistent implementation should be ensured. In particular, the LCBR mandates the EC to present a report to the co-legislators to review the minimum standards for CTB and PAB to align them with the Taxonomy Regulation by 31 December 2020. In addition, administrators of significant benchmarks shall indicate in their benchmark statement how their benchmarks align with the target of reducing carbon emissions 'in accordance with the disclosure rules' under Article 9 of the Disclosures regulation ("SFDR"). Both the Taxonomy and the SFDR are not yet operational whereas they are both subject to a) phase-in of requirements and b) the need for Level 2 guidance, which is currently being developed.

Moreover, as stated in the joint ISDA and AFME response to the European Commission's consultations on the three draft Delegated Acts (DAs), for the purpose of specifying requirements under the Low Carbon Benchmarks Regulation, neither the BMR nor the proposed Delegated Acts set out the minimum conditions for a benchmark to be considered as pursuing ESG objectives. This approach may lead to the creation of benchmarks labelled as ESG with divergent, poor or incidental ESG scorings which do not justify the labelling as ESG. Investors who may consider the ESG label of a benchmark as a standalone factor to make an investment decision could therefore be misled. We thus encourage the Commission to set out a clear definition of "ESG objectives" to ensure that all ESG-labelled benchmarks meet a minimum standard of what is considered ESG in addition to the underlying factor disclosures.

Market participants are already faced with several implementation challenges in respect of the current carbon benchmarks requirements and other sustainable finance obligations, especially in the current context, which puts significant strain on firms' time and resources. In light of the above, ISDA is of the view that it would be premature to determine the need for further regulated benchmarks until a) the two optional designations have been fully operational, b) relevant sustainable finance regulations have been implemented and c) affordable, reliable, comparable and relevant ESG data have become available.

Question 34: Beyond the possible standards and labels mentioned above (for bonds, retail investment products, investment funds for professional investors, loans and mortgages, benchmarks), do you see the need for any other kinds of standards or labels for sustainable finance?

- Yes/**No**/Do not know.
- If yes, what should they cover thematically and for what types of financial products? [box max. 2000 characters]

Additional comment:
Currently we do not foresee the need for new standards or labels. At this stage it is important to monitor the uptake by the market of the standards already developed or under development in recent years, including the Taxonomy on green activities.

Should the European Commission decide to take action in this space at a later stage, it should clarify the scope of products and provide clarity to market participants on what to expect and by when. While there are some benefits of standards/labels such as uniform criteria, simplification and improvement of due diligence that banks have to undertake to decide whether a financing is sustainable or not, any regulatory action taken should avoid fragmentation and a multiplicity of labels which could result in inefficiencies and greater costs for the industry.

Please refer to additional comments relevant to securitisation transactions in a separate paper **AFME response to EC on Renewed Sustainable Finance (Green Securitisation) 15 July 2020.**

1.5 CAPITAL MARKETS INFRASTRUCTURE

Question 35: Do you think the existing capital market infrastructure sufficiently supports the issuance and liquidity of sustainable securities?

- Please express your view by using a scale of 1 (strongly disagree) to 5 (strongly agree).
- For scores of 1 and 2, please list the main problems you see (maximum three). [BOX, 2000 characters].

4 – Agree

Additional comment: Please refer to additional comments relevant to securitisation transactions in a separate paper **AFME response to EC on Renewed Sustainable Finance (Green Securitisation) 15 July 2020**.

Question 36: In your opinion, should the EU foster the development of a sustainable finance- oriented exchange or trading segments that caters specifically to trading in sustainable finance securities and is better aligned with the needs of issuers?

- Yes/**No**/Do not know.
- If necessary, please explain the reasons for your answer. [BOX max. 2000 characters]

AFME does not see the benefit of the EU developing such an exchange or trading segment by regulation or other policy. While ESG segments of stock exchanges can be helpful to allow investors to quickly identify issuers which have met certain standards and make investment decisions accordingly, segmenting ESG labelled securities into dedicated exchanges will fragment liquidity in the market, while requiring increased reporting and processes. The liquidity of the sustainable segment is suffering, among others, from the same regulatory pressure than the non-sustainable bond market. ESG segments on stock exchanges or quotation pages could help investors in their stock picking but will not substantially change the landscape of their investments. Sustainable instruments/markets should remain as mainstream as possible, enabling issuers to access new pools of capital and acting as a price discovery function. ESG has become another lens that investors apply and is no longer a fully niche field, and policymakers should be promoting integration and deep liquidity, not further fragmentation.

ESG-labelled securities are only one product used in a capital structure or across an asset manager. As an example, while green bonds may be bought by investors for green only funds, they are also bought by investors for regular credit funds, thus limiting the trading of these bonds to specific segments may hamper their liquidity. In a similar vein, although ESG derivatives can help develop the transfer and price-discovery of ESG-related risks, "standard" derivatives can still be used within an ESG construct as an essential risk transference tool.

Whilst ESG labelling might be the ultimate objective for the future, we are concerned that an unrealistic timetable or sudden introduction of these regulatory requirements could de-stabilise the markets by triggering sell off of non-ESG securities. Such a market change should be introduced gradually, allowing developments to be made on the supply-side (issuer-side) before the demand-side (investor/market side) obligation is legislated.

We note that experience of dedicated exchanges has not been positive: for example, new exchanges created for technology stocks during the technological boom were unnecessary and fragmented markets.

Additional comment: Please refer to additional comments relevant to securitisation transactions in a separate paper **AFME response to EC on Renewed Sustainable Finance (Green Securitisation) 15 July 2020**.

Question 37: In your opinion, what core features should a sustainable finance–oriented exchange have in order to encourage capital flows to ESG projects and listing of companies with strong ESG characteristics, in particular SMEs?

- [BOX max. 2000 characters]

As noted in our answer to Question 36, AFME believes existing infrastructure is already fit for supporting sustainable finance, however introducing additional markers to differentiate sustainable products would be needed. A uniform set of criteria which all investors feel they can rely on would be a core feature of such markers. In this respect, the EU Taxonomy is also helpful.

If the EU were to introduce a separate sustainable finance-oriented exchange, the following principles must be ensured to follow:

- Standardised disclosure and reporting – with a limited standard for SMEs
- Embedded external review
- Major currencies
- No additional reporting requirements to the exchange (adopt EU rules)

- Encourage all major issuers – particularly the SSAs – to only issue on the exchange to drive activity by investors
- Low operating costs
- Cost control management
- Global access
- Strong management committee
- Independent executive directors

1.6 CORPORATE GOVERNANCE, LONG-TERMISM AND INVESTOR ENGAGEMENT

Question 38: In your view, which recommendation(s) made in the ESAs' reports have the highest potential to effectively tackle short-termism? Please select among the following options.

- Adopt more explicit legal provisions on sustainability for credit institutions, in particular related to governance and risk management;
- Define clear objectives on portfolio turn-over ratios and holdings periods for institutional investors;
- Require Member States to have an independent monitoring framework to ensure the quality of information disclosed in remuneration reports published by listed companies and funds (UCITS management companies and AIFMs);
- **Other, please specify**. [box max. 2000 characters]

One of the most important recommendations expressed by the ESAs is "*the adoption of more explicit legal provisions on sustainability for credit institutions, in particular relating to governance and risk management*".

A gradual and proportional application of these provisions should be applied and envisage disclosure of arrangements, processes, products and strategies the financial institutions intend to implement to measure and manage ESG risks and to finance sustainable growth. Additionally, these provisions should envisage adequate and consistent disclosure of ESG relevant information from corporates (including SMEs).

In addition to the above, of particular relevance is also the EBA's recommendation for the "*improvement of information flows and data access systems, to support the role of the banking sector in raising awareness among businesses, SMEs and retail customers on the challenges of sustainability and ESG risks*". Creating resources and platforms to support information sharing on the impact of ESG factors on long-term business risks and opportunities might help fundamentally reshape investment preferences and business models.

Question 39: Beyond the recommendations issued by the ESAs, do you see any barriers in the EU regulatory framework that prevent long-termism and/or do you see scope for further actions that could foster long-termism in financial markets and the way corporates operate?

- **Yes**/No/Do not know.
- If yes, please explain what action(s). [BOX max. 2000 characters]

The following actions could help to reduce barriers and foster the supply of sustainable long-term lending and investments:

1. Developing a uniform definition of ESG risks and methodologies for measuring the impact of ESG risks on corporations (including the interrelation with credit risk), in alignment with emerging international standards and definitions.
2. Setting principles and requirements that can ensure, by industry, comparability and reliability in the disclosure of ESG risk and impacts (green washing risk mitigation).
3. Strengthen the accountability of ESG impacts on accountability towards all stakeholders, and not only direct shareholders.
4. Favouring innovation in sustainable finance to identify new instrument which can better support the transition toward sustainable business model (es. ESG-Linked Loans; SDG KPI-linked bonds; Impact Loan; Blended Finance products; Green Project Finance etc.).
5. Incentivise sharing of examples and experience across countries and among financial institutions.

Question 40: In your view, should there be a mandatory share of variable remuneration linked to non-financial performance for corporates and financial institutions?

- Yes/**No**/Do not know.
- If yes, please indicate what share. [box 2000 characters]

Question 41: Do you think that a defined set of EU companies should be required to include carbon emission reductions, where applicable, in their lists of ESG factors affecting directors' variable remuneration?

- Yes/**No**/Do not know.

Additional comment:

We believe that executive pay policies should use performance measures that are closely linked to the company's long-term strategy and goals to ensure that executives are rewarded for delivering strong and sustainable returns over the long-term, as opposed to short-term hikes in share prices. We support incentive plans that foster the achievement of results in a sustainable way, i.e. by considering the financially most material indicators. We believe that companies should identify those performance measures most directly tied to shareholder value creation, and that emphasis should be on those factors within management's control to create economic value and sustained shareholder returns over the long-term. ESG risks and opportunities that are identified to be material in the firm's own analysis should be part of this set of indicators. Similarly, the vesting timeframes associated with incentive plans should facilitate a focus on long-term value creation, as appropriate to that particular company. We further stress that such executive pay policies should be applicable to financial and non-financial firms alike.

Question 46: Due regard for a range of 'stakeholder interests', such as the interests of employees, customers, etc., has long been a social expectation vis-a-vis companies. In recent years, the number of such interests have expanded to include issues such as human rights violations, environmental pollution and climate change. Do you think companies and their directors should take account of these interests in corporate decisions alongside financial interests of shareholders, beyond what is currently required by EU law?

- **Yes, a more holistic approach should favour the maximisation of social, environmental, as well as economic/financial performance.**
- Yes, as these issues are relevant to the financial performance of the company in the long term.

- No, companies and their directors should not take account of these sorts of interests.
- I do not know.

Question 47: Do you think that an EU framework for supply chain due diligence related to human rights and environmental issues should be developed to ensure a harmonised level-playing field, given the uneven development of national due diligence initiatives?

- **Yes**/No/Do not know.

Additional comment:

A harmonised EU standard should be developed, taking into account planned and existing requirements in other jurisdictions (e.g. on modern slavery in the UK and Australia).

Question 48: Do you think that such a supply chain due diligence requirement should apply to all companies, including small and medium sized companies?

- **Yes**/No/Do not know.
- If yes, please select your preferred option:
  - All companies, including SMEs.
  - **All companies, but with lighter minimum requirements for SMEs.**
  - Only large companies in general, and SMEs in the most risky economic sectors sustainability-wise.
  - Only large companies.
- If necessary, please explain the reasons for your answer. [box max. 2000 characters]

2. INCREASING OPPORTUNITIES FOR CITIZENS, FINANCIAL INSTITUTIONS AND CORPORATES TO ENHANCE SUSTAINABILITY

2.1 MOBILISING RETAIL INVESTORS AND CITIZENS

Question 49: In order to ensure that retail investors are asked about their sustainability preferences in a simple, adequate and sufficiently granular way, would detailed guidance for financial advisers be useful when they ask questions to retail investors seeking financial advice?

- **Yes**/No/Do not know.
- If necessary, please provide an explanation of your answer. [box max. 2000 characters]

It would be helpful for such guidance to be developed in consultation with financial services providers from all parts of the retail servicing spectrum, from product manufacturers to financial advisers, so that the guidance is on the one hand sufficiently flexible to meet the disparate and evolving needs of different retail investors across the Union and on the other hand to provide a degree of standardisation by making sure that everyone is working towards answering the same questions.

The guidance needs to be sufficiently flexible to take into account the need for transition financial products (rather than just being focused on "green" products, for example) and to be able to evolve with the needs of consumers and society as a whole.

Question 50: Do you think that retail investors should be systematically offered sustainable investment products as one of the default options, when the provider has them available, at a comparable cost and if those products meet the suitability test?

- **Yes**/No/Do not know.

Additional comment:

AFME supports retail investors being offered sustainable investment products as one of the default options, where the provider of such products has them available and if those products meet the suitability test. However, we believe that the requirement for such products to be offered "at a comparable cost" should be deleted as it could restrict the scope of suitable products that are offered to retail investors. For example, retaining the reference to "comparable costs" could imply that retail investors should not be offered financial products that are otherwise suitable for (and/or of interest to) them if such products are not comparable in cost to sustainable investment products.

In addition, retaining the reference to "comparable costs" could also imply that, where sustainable finance products and non-sustainable finance products meet a retail investor's needs, the dealer would have to make the costs of the two products comparable before offering such products to the retail investor.

In AFME's view, any requirement for retail investors to be systematically offered sustainable investment products as one of the default options should be flexible enough to avoid restricting the scope of suitable products that are made available to such investors.

Question 51: Should the EU support the development of more structured actions in the area of financial literacy and sustainability, in order to raise awareness and knowledge of sustainable finance among citizens and finance professionals? Please reply using a scale of 1 (completely disagree) to 5 (fully agree)

4 – Agree

- If you agree (for scores of 4 to 5), please choose what particular action should be prioritised:
  - Integrate sustainable finance literacy in the training requirements of finance professionals. [1-5] 5- Fully agree
  - Stimulate cooperation between Member States to integrate sustainable finance as part of existing subjects in citizens' education at school, possibly in the context of a wider effort to raise awareness about climate action and sustainability. [1-5] 4 – Agree
  - Beyond school education, stimulate cooperation between Member States to ensure that there are sufficient initiatives to educate citizens to reduce their environmental footprint also through their investment decisions. [1-5] 4 – Agree
  - Directly, through targeted campaigns. [1-5] 4 – Agree
  - As part of a wider effort to raise the financial literacy of EU citizens. [1-5] 4 – Agree
  - As part of a wider effort to raise the knowledge citizens have of their rights as consumers, investors, and active members of their communities. [1-5] 4 – Agree
  - Promote the inclusion of sustainability and sustainable finance in the curricula of students, in particular future finance professionals. [1-5] 5 – Fully agree
  - Other, please explain. [box max. 2000 characters]

Additional comment:

We also support:

- promotion of EU certified courses in financial literacy (and sustainability) as part of compulsory training programmes at firms;
- promoting the adoption of new approaches in designing financial literacy programmes, aimed at including sustainable finance topics.

2.2 BETTER UNDERSTANDING THE IMPACT OF SUSTAINABLE FINANCE ON SUSTAINABILITY FACTORS

Question 52: In your view, is it important to better measure the impact of financial products on sustainability factors?

- Please express your view by using a scale of 1 (not important at all) to 5 (very important).
- For scores of 4 to 5, what actions should the EU take in your view? [BOX max. 2000 characters]

5 - Very important

It is very important to better measure the impact of products that market themselves as having an impact on sustainability. The IFC Operating Principles for Impact Measurement are a good guide for this.

However, products that neither pursue sustainable investments nor consider principal adverse impact (e.g. funds with just climate aware strategies) should not be required to provide an impact assessment. Therefore, in the EU Disclosure Regulation terminology, only those funds having a sustainable investment as their objective (Article 9) should disclose the impact.

A further consideration could be for the EU to monitor the levels of ESG investments, e.g. on an annual basis. Better measurement the impact of financial products on sustainability factors would require the development of standards to define what impact means and how it can best be measured.

In order for investment managers to disclose impact, and for this impact to be monitored, a harmonised definition of impact should first be developed.

Question 53: Do you think that all financial products / instruments (e.g. shares, bonds, ETFs, money market funds) have the same ability to allocate capital to sustainable projects and activities?

- **Yes**/No/Do not know.
- If no, please explain what you would consider to be the most impactful products/instruments to reallocate capital in this way. [box max. 2000 characters]

Generally, both bonds and shares/general funds have the ability to allocate capital to sustainable projects and activities.

At this stage, green/social/sustainability bonds, financing a specific sustainable asset/project, would result in a more direct allocation of capital to a sustainable activity than, for example, some equity funds. This is because the ESG investment frameworks/practices behind green/social/sustainability bonds have developed further than for other products, allowing for clear contractual agreement around the use of proceeds.

However, funds, such as large volume products, can by their volume measure alone support the allocation of significant capital towards sustainable activities.

There are products or instruments, such as money market funds, that will likely have a more limited impact potential unless underlying assets are invested in very specific fixed income securities such as multi-lateral development bank debt securities. There may also be a limited impact in the investment in public equities per se unless active engagement and stewardship strategies are employed with specific sustainability objectives.

With respect to ETFs and index funds, and for these passive products to be able to allocate capital to sustainable projects and activities in a meaningful way, more sustainable indices should be made available as a prerequisite (for example on the Fixed Income side).

Generally, it is important that sustainable finance permeates all products, as equity participation will support the overall sustainability strategy. The EU's priority should therefore be to further develop EU capital markets to create and sustain an equity culture in Europe which would drive sustainability.

2.3 GREEN SECURITISATION

Question 54: Do you think that green securitisation has a role to play to increase the capital allocated to sustainable projects and activities?

- Please express your view by using a scale of 1 (not important at all) to 5 (very important).
- If necessary, please explain your answer. [box, max. 2000 characters]

5- Very important

We strongly believe that ESG securitisation can play an important role in increasing capital allocated to ESG projects and activities. Securitisation allows for capital market investors to contribute to specific projects and activities in a risk-appropriate manner and it constitutes an important tool for financial institutions in managing capital, leverage and funding (whether the securitisation is a synthetic securitisation or a 'cash' securitisation). Securitisation provides banks and other originators with a tool for transferring assets out of their balance sheet, thus increasing their capacity for lending to ESG projects and by pooling together small ESG loans (such as mortgages, residential rooftop solar energy, small SME loans for energy efficiency projects, and small scale infrastructure projects) into more liquid assets, securitisation gives investors access to sustainable investments.

As discussed in our Green Securitisation Position Paper, demand for green (and ESG) securitisation bonds is increasing and the availability of a sufficient supply of ESG collateral to meet this growing demand will be critical. Many institutional investors have increased commitments to invest in ESG assets in line with policy objectives and we are seeing an increasing number of queries and investor demands for ESG securitisation, indicating that the appetite and interest are there and that this market has considerable potential to grow. We note the institutional and stakeholder support for green securitisation. In its report published on 10 June 2020, the High-Level Forum on the Capital Markets Union[12] notes that securitisation has an enormous potential "to advance capital markets union and green finance" and that "funding the ambitious EU Green Plan also needs a functioning securitisation market". However, we note the importance of shifting away from the narrower concept of green securitisation and to start focusing more on the wider concept of ESG securitisation.

Furthermore, there is potential for the growth of ESG securitisation in both 'cash' and in synthetic variants. Each variant has a key role in driving lending and investment decisions within firms and could be an important tool in creating positive incentives for the origination of green assets, in particular if differentiated markets for green securitisation develop and are well functioning/ regulated.

Question 55: Do the existing EU securitisation market and regulatory frameworks, including prudential treatment, create any barriers for securitising 'green assets' and increasing growth in their secondary market?

- **Yes**/No/Do not know.
- If yes, please list the barriers you see (maximum three). [BOX max. 2000 characters]

[12] https://ec.europa.eu/info/sites/info/files/business_economy_euro/growth_and_investment/documents/200610-cmu-high-level-forum-final-report_en.pdf

AFME very much supports the development of the STS framework set out in the Securitisation Regulation and its objective to restart the securitisation market. Yet the potential of the framework and the ambition to promote a safe and expanded European securitisation market are so far not being fulfilled. This is in part due to an excessively complex regulatory framework and an overly conservative treatment of securitisation that continue to discourage a meaningful recovery of the European market. In this respect, the regulatory capital treatment of securitisation transactions under CRR, Solvency II as well as the LCR rules remain an area of concern. These elements may have an indirect impact on the development of a market for ESG securitisation.

Question 56: Do you see the need for a dedicated regulatory and prudential framework for 'green securitisation'?

- Yes/No/Do not know.
- If yes, what regulatory and/or prudential measures should the dedicated framework contain and how would they interact with the existing general rules for all securitisations and specific rule for STS securitisations? [box max. 2000 characters]

The Securitisation Regulation regulates all securitisations in Europe and should be the context for the development of principles and practices for ESG securitisation. Any dedicated regulatory framework for ESG securitisation should be developed in line with or within the existing Securitisation Regulation framework rather than independently to avoid duplication or inconsistency.

The introduction of differentiated capital treatment for ESG securitisation, which recognises ESG criteria in line with our response to Question 88 and the work currently being undertaking by the EBA and the international fora, may incentivise market participants and make a material difference to the growth of the ESG securitisation market. At this stage, there is limited evidence of a risk differential between ESG and non-ESG (or brown) assets. Accordingly the development at an international level of risk assessment methodologies that include a forward-looking perspective to better take into account the impact of ESG factors on the long-term risk profile of assets and related prudential treatment would be extremely helpful. Please see our response to Question 88 for further information.

2.4 DIGITAL SUSTAINABLE FINANCE

Question 57: Do you think EU policy action is needed to maximise the potential of digital tools for integrating sustainability into the financial sector?

- Yes/No/Do not know
- If yes, what kind of action should the EU take and are there any existing initiatives that you would like the European Commission to consider? Please list a maximum of three actions and a maximum of three existing initiatives. [BOX max. 2000 characters]

Many European financial institutions are already exploring the use of digital finance tools in the area of sustainable finance, for example for improved ESG risk management, for expanding their respective impact investment business and for better sourcing and disclosing of ESG data. Digitisation tools, such as artificial intelligence (AI) and machine learning (ML), enable financial institutions to obtain new types of ESG data (e.g. geospatial imaging) as well as greater volumes of ESG data (e.g. through faster processing of media articles and social media), hence generating better visibility and transparency around ESG risks and/or impacts. At the same time, digitisation is an important driver for financial inclusion (e.g. automating KYC processes, creating digital identities, processing credit assessments online), which in its turn has the potential for driving economic growth and mobilising additional funding towards international sustainability agendas such as the Sustainable Development Goals (SDGs). We therefore encourage further EU policy action for maximising the potential of digital tools for further integrating sustainability in the financial sector.

To enable the financial sector to develop efficient tools that contribute to the sustainable transition of the economy, the EU regulatory framework should be technology neutral and innovation friendly, without imposing an unnecessary burden on financial services providers vis- a vis other players such as platforms.

New technologies such as Artificial Intelligence and Distributed Ledger Technology (DLT) could also play an important role in developing sustainable tools. However, in order to fully realise their benefits, the Commission should implement a cross-sectoral approach to data sharing that allows the sharing of relevant ESG data across key sectors.

For example, greater sharing of data on emissions, energy usage, and climate risk mapping will be key in identifying more sustainable products and services and ways of doing business. We therefore invite the Commission to facilitate the development of data ecosystems for the sharing of relevant ESG data.

We welcome the proposals put forward in the European Strategy for Data on creating Common European Data Spaces to facilitate the greater sharing of relevant data between market participants. A "European Green Deal Common data space" may support access to and sharing of data that is useful across a number of different sectors, including the financial sector. The financial sector could use relevant data to contribute to its role in helping market participants and the wider economy meet their sustainability objectives, including through better climate change related risk assessments, or the provision of green-loans.

In addition, innovation forums provide a place to share best practices while regulatory sandboxes provide opportunities to test new digital tools in a safe environment. We recommend that the Commission continues to support innovation forums such as the European Forum for Innovation Facilitators (EFIF) and to further develop regulatory sandbox testing environments in order to maximise the potential of digital tools for integrating sustainability.

Question 58: Do you consider that public authorities, including the EU and Member States should support the development of digital finance solutions that can help consumers and retail investors to better channel their money to finance the transition?

- **Yes**/No/Do not know.
- If yes, please explain what actions would be relevant from your perspective and which public authority would be best-positioned to deliver it. Please list a maximum of three actions [BOX max. 2000 characters]

In addition to supporting the development of new technologies such as AI and DLT, collaboration between the industry and public authorities will be key in supporting the development of digital finance solutions. Digital tools can play important role in helping consumers and retail investors with reference to:

- Strengthening projects and corporates' ESG goals accountability towards all stakeholders (shareholders; customers; communities can check and compare ESG metrics);
- Easing of burdensome and complex process processed related to verifying taxonomy compliance of activities and/or investment and check KPIs; and
- Fostering innovative and sustainable financial instruments. For example, digital tools could allow citizens / consumers to participate via crowd funding or social lending, in the financing of

ESG projects; interest rate on projects loans could be linked to ESG KPIs, which retail investors/ lenders could check online.

Currently, digital tools and platforms operate mainly at a domestic level, therefore removing any potential barriers against using these platforms and tools across borders would further encourage their use.

The use of digital tools should be promoted as the link between digitisation and sustainability can become a cultural behaviour for this and for future generations.

EU citizens should be provided with clear and comprehensive information about sustainable projects by improving disclosure requirements to customers prior and during investment. It is important to enhance the level of education and literacy around sustainable investing through providing training, including that offered on digital platforms, public websites, smartphone applications, etc.

Question 59: In your opinion, should the EU, Member States, or local authorities use digital tools to involve EU citizens in co-financing local sustainable projects?

- **Yes**/No/Do not know.
- If yes, please detail, in particular if you see a role for EU intervention, including financial support. [BOX max. 2000 characters]

Digital tools could provide useful opportunities to make co-financing of local sustainable projects more accessible for EU citizens and firms. DLTs provide one relevant example. For instance, the adoption of DLT for Green Bonds may enable them to reach and create new markets at both ends of the investment pipeline. DLT-based Green Bonds could facilitate more efficient bond markets, increasing investor confidence, improving wider capital flows and reducing the cost of reporting. However, it is important to note that further investment in DLT from the industry and authorities is necessary, particularly from a scalability perspective. This issue may require policy action from authorities.

1. **2.5. PROJECT PIPELINE**

Question 60: What do you consider to be the key market and key regulatory obstacles that prevent an increase in the pipeline of sustainable projects? Please list a maximum three for each.

- BOX max. 2000 characters

Key market obstacles:

1. Undeveloped capitals markets for certain sectors – for example, market barriers limit the pipeline of energy efficiency projects, particularly relevant in building retrofitting, despite its great potential to reduce energy consumption and emissions in Europe. On the borrowers' side there is a shortage of technical know-how, uncertainty over savings, high transaction costs, difficulty to access long term finance, long payback times and a lack of funds for feasibility studies and audits. On the financial institutions' side, there is limited experience in assessing loans applications for energy efficiency and their bankability, and absence of standardised measurement and verification procedures. Specific financial and advisory instruments implemented both at the European and national level could help overcome those barriers. The application of grants and fiscal incentives for energy saving measures may also reduce transaction cost and facilitate the creation of market demand. National programs combining energy savings obligations with the right adaptation of legislation, especially laws governing communities of property owners, are essential in some markets to increase bankability of investment projects.

2. Risk - green and other sustainable assets, while achieving a societal goal and potentially yielding good returns, are not without risk. In fact, the complex, idiosyncratic, nature of the underlying sustainable projects / assets may increase their risk due to:
   - Location – consistent with the points above, the need for most sustainable investment is in parts of the world where credit risk is high, meaning many long-term providers of capital, such as pension funds, may not be able to invest there.
   - Regulatory and environmental approvals – projects are subject to environmental and historical impact assessments; public consultation periods can be lengthy and not always end with approvals, increasing uncertainty.
   - Technology – While some technology is well-proven and has been commoditised like photovoltaic (PV) systems and wind turbines, some technology, e.g. batteries and plastics recycling, are still being commercialised and carries high risks. Technology uncertainties include availability of relevant standards/benchmark technologies and availability of industrial scale technology. Technology uncertainties significantly limit the number of potential investors (and capital available) as technology risk is only acceptable to industrial players or financial investors with very high risk/return profiles. This in turn leads to slow deployment and flat learning curves/slow cost reduction in the cost of such technologies. As technology evolves and standards emerge, we expect this obstacle to decrease and the market to accelerate (similar to renewable power generation since the late 1990s).
   - Further work needs to be done around methodologies on how to incorporate ESG related risks in credit ratings (please also see our answers to Section 3)
3. Investor knowledge and participation - Investors should build their own knowledge on green/sustainable products, which requires investments in market education. Additionally, the framework should enhance the participation of retail investors.
4. Developing regulation - regulation around sustainable finance has just started to evolve and presents challenges for companies, including corporates, to stay up to date with the fast-evolving developments. This also contributes to information asymmetry or lack of knowledge about valid sustainable investment options, which in turn can contribute to ROI still being perceived as higher for non-sustainable projects. It is important to ensure optimal regulatory convergence, for example through coherent taxonomies and definitions at global level.

Key regulatory obstacles:

1. Clarity on economic policies and policy framework to incentivise/ease the transition

   Regulatory obstacles mainly consist of regulatory uncertainty that often stems from a mismatch between policy objectives and implementation policies, by frequent changes (tightening) in policy or diverging policies between Member States. Regulatory uncertainties often have very long-term effects as they prevent or stop early stage developments including for the duration of the policy development.

   Further clarity on real economy policies, for example related to energy production, transportation, industrial outputs, and agriculture would be necessary to better understand the long-term financial viability of certain investments. While the Paris Agreement provides the targets and timelines, investors need a firm policy framework built round trajectories towards those targets. That policy certainty would reassure investors and corporates that there is a strong commitment and a plan as to how to meet the stated transition ambitions over the timelines, considering the technological progress made to date and that required in the future to meet the sustainability policy objectives. The EU Green Deal is an excellent starting point in this regard.

Commitments from governments to longer term infrastructure plans and programmes can also help reduce project risk, along with incentives for sustainable projects, and help to provide a clear direction of travel regarding taxation and carbon pricing. The experience of the automotive industry after the 2008 financial crisis is a good illustration of what could be achieved in the COVID-19 Recovery plans. The requirements introduced for the US auto manufacturers, directing bailout funds towards investments in electric vehicles, provided a strong steer as to the direction of policy and helped speed up the industry's transition, which is now well under way.

2. Administrative burdens/compliance verification/lack of usability and data availability

   Verifying compliance with the new sustainable finance related regulation (e.g. Taxonomy) often involves a burdensome process for businesses, for example, relating to the necessary data collection and reporting. It would be important to encourage SMEs to participate in the transition, for example through, at least temporary, lighter environmental performance thresholds under the EU taxonomy.

   Taxonomy and disclosures duties should be closely linked. Concerning the EU framework, the disclosures duties foreseen for the financial market participants according to the taxonomy regulation should be fully aligned with the disclosure duties foreseen for the industrial sectors in the review of the EU's NFRD. Furthermore, to ensure data usability, market participants will need an approach to comply with disclosure requirements that is as automated as possible. In this regard, further alignment of taxonomies would be beneficial, to prevent double accounting of sustainable activities and to facilitate usability.

3. Timeline and Concentration

   Potential funders, such as sovereign wealth funds, banks and long-term investors who act as fiduciaries, cannot risk significant tranches of their portfolios on financing these projects. Banks, Investors, and asset managers frequently have industry, country, credit quality concentration limits that create upper limits on exposures. The cumulative nature of projects underwritten means that these concentration limits can be reached relatively quickly with new large projects in specific sectors.

   As many of these assets are longer term in nature, such investors cannot directly finance individual projects as they would face unacceptable levels of over-exposure to a single name risk.

4. Liquidity

   A further barrier to greater flows of funds to sustainable projects is investor liquidity requirements. Sustainable infrastructure projects are typically highly illiquid; this illiquidity makes their valuation difficult on a real-time basis, a requirement for some portfolios (no Mark-to-market).

   Most financial institutions have fiduciary and prudential obligations to maintain greater portions of their portfolios in liquid, investment grade, publicly traded assets as opposed to non-liquid assets. In the wake of a number of well-publicised problems with retail investment funds, regulators are naturally stepping up the reporting requirements to include 'illiquids.' Regulators have rightly placed strict liquidity requirements on institutions, but this has an unintended effect of limiting the green finance they can undertake, due to their often illiquid nature.

   Existing frameworks like Basel III discourage the financing of sustainable economic activities by requiring financial institutions and insurers to allocate sizeable amounts of capital and liquidity cover to support investments in long-term debt. Capital charges are not adjusted to actual asset-risk profiles of infrastructure projects, thus limiting the rate of return of holding infrastructure-linked debt instruments and the capacity to crowd-in resources from commercial banks, insurers and other institutional investors to sustainable investments. Although recent regulatory improvements in CRR II and Solvency II now provide significant relief for certain high quality infrastructure debt relative to equivalent corporate bonds and loans, such more favourable treatment remains restricted to investments in OCDE countries, and sustainable infrastructure projects in many emerging and developing countries do not benefit from them.

Question 61: Do you see a role for Member States to address these obstacles through their NECPs (National Energy and Climate Plans)?

- **Yes**/No/Do not know
- If necessary, please provide details. [box. Max. 2000 characters]

The creation of a larger and more unified market, e.g. through better interconnection and common rules, is important to avoid regulatory fragmentation across Member States. For example, the lack of consistent green energy growth policies and long-term targets has contributed to limited pipelines and low investor confidence.

It could therefore be useful if the NECPs would include fiscal incentive frameworks and/or other benefits to propel sustainable finance. Furthermore, an investment push from Member States, coupled with consistent policies, legal frameworks, right set of incentives and financial instruments targeted at renewable energy technologies, sustainable mobility infrastructure and energy efficiency improvements would allow the private sector and civil society stakeholders the necessary certainty to take long-term decisions and accelerate the transition to low-carbon economies, triggering additional cost reductions through scale economies and innovation.

Question 62: In your view, how can the EU facilitate the uptake of sustainable finance tools and frameworks by SMEs and smaller professional investors? Please list a maximum of three actions you would like to see at EU-level

- [BOX max. 2000 characters]

The below actions could support SME and smaller professional investor uptake in sustainability:

- Increasing sustainable financial literacy with SMEs is important to raise awareness around energy-efficiency and renewable energy investment opportunities, among others. In general, there is a lack of knowledge about the economic benefits of green investments and green technologies available among SME borrowers, who at times have poor understanding of the potential paybacks and productivity benefits. Green investment is often regarded as an opportunity cost compared to expanding production. Initiatives like the EBRD's Green Economy Financing Facility point in the right direction by making available advisory services to borrowers and partner financial institutions for energy assessments, training and marketing support, and by providing web-based tools for selection of the best technology solution and identification of reliable suppliers and installers.
- The EIB Group and other European and public promotional institutions could address these issues through dedicated, innovative SME products delivered via financial intermediaries. Specific credit guarantee facilities would reduce collateral requirements and stimulate development of standard green banking products for SMEs.

Question 63: The transition towards a sustainable economy will require significant investment in research and innovation (R&I) to enable rapid commercialisation of promising and transformational R&I solutions, including possible disruptive and breakthrough inventions or business models. How could the EU ensure that the financial tools developed to increase sustainable investment flows turn R&I into investable (bankable) opportunities?

- [Box max. 2000 characters]

While many European firms are very innovative and operate in high-tech areas, they can face difficulties in scaling up. Public investment in R&I in the EU is on a par or higher compared to other jurisdictions, however, industrial deployment of innovation is still facing obstacles. The EU should therefore look to:

- support companies and their R&I projects through financial structures that are inclusive (crowd-in) vis-à-vis private capital;
- implement refined public programmes and financial instruments that remove barriers to sustainable innovation and attract more private investment, in line with Horizon 2020 or the EIC Accelerator, with increased capacity and streamlined application processes;
- build on the experience gained in the Public-Private Partnerships in H2020, to develop a dynamic industrial innovation ecosystem involving broad research and innovation communities.

Support could come in the form of grants, debt financing or equity where market response is insufficient, including the provision of venture debt and venture capital. It is important to address different stages of the innovation cycle, including high-risk, high-reward research programmes. It is also necessary to cover different types of applicants to retain research talent and foster innovation across Europe, including innovative entrepreneurs, SMEs and midcaps with business plans and early-stage or advanced clean energy and resource efficient technologies, processes or services that can be brought to the market and scaled up.

Without a combination of public and private investment in cases where markets alone cannot meet the demand for capital, Europe risks underinvesting in the large-scale deployment of innovative technologies in strategic value chains. This seems to be particularly true in the post COVID-19 environment. Depending on the companies' development stage, capital needs, and R&D development, a range of funding schemes at EU and national level can be mobilised to incentivise, leverage and/or 'de-risk' private investment.

From a bankability point of view, we believe the below should be considered to help introduce innovative financial instruments:

- Blended finance supporting early-stages of R&I projects
- Guarantee system for financing later stages of the projects
- Equity financing through a dedicated EU Green Deal Fund, funded by EU, national and regional capital and structured as co-investment with other investors, to crowd in private financing

Question 64: In particular, would you consider it useful to have a category for R&I in the EU Taxonomy?

- **Yes**/No/Do not know

Question 65: In your view, do you consider that the EU should take further action in:

- Bringing more financial engineering to sustainable R&I projects? **Yes**/No
- Assisting the development of R&I projects to reach investment-ready stages, with volumes, scales,

and risk-return profiles that interest investors (i.e. ready and bankable projects that private investors can easily identify)? Yes/No

- Better identifying areas in R&I where public intervention is critical to crowd in private funding? Yes/No
- Ensuring alignment and synergies between Horizon Europe and other EU programmes/funds? Yes/No
- Conducting more research to address the high risks associated with sustainable R&I investment (e.g. policy frameworks and market conditions)? Yes/No
- Identifying and coordinating R&I efforts taking place at EU, national and international levels to maximise value and avoid duplication? Yes/No
- Facilitating sharing of information and experience regarding successful low-carbon business models, research gaps and innovative solutions? Yes/No
- Increasing the capacity of EU entrepreneurs and SMEs to innovate and take risks? Yes/No
- If necessary, please explain your answer. [Box max. 2000 characters]

The creation of special category for research & innovation in the EU Taxonomy would help increase the visibility and commercialisation of valuable inventions, attracting further private finance to innovation in technologies for energy savings, efficient energy generation, energy storage and transmission.

2.6 INCENTIVES TO SCALE UP SUSTAINABLE INVESTMENTS

Question 66: In your view, does the EU financial system face market barriers and inefficiencies that prevent the uptake of sustainable investments?

- Please express your view on the current market functioning by using a scale of 1 (not well functioning at all) to 5 (functioning very well).
- Please specify your answer. [BOX max. 2000 characters]

2-Rather not well functioning

We have pointed to many barriers in our responses to questions 17-21, including a lack of standardisation and common metrics across the ESG ecosystem; poor disclosure by corporatess; non-comparable industry ESG data; and inconsistent methodologies used by ESG rating agencies. Other points include:

- lack of a centralised database on ESG data categorised by industry or of digital platforms with tools and AI instruments available for a preliminary assessment of counterparties' ESG risk. There is a need for systematic tagging of sustainable-related loans and tracking correlation between sustainable lending and credit risk. Such tools could support the role of the banking sector in providing financial solutions which may support companies to manage ESG risk and incentivise them to adopt sustainable business models.
- high transaction costs and IT development needs around monitoring, extensive reporting and verification requirements for some lending facilities. Having to comply with complex technical requirements for eligible investments and using expensive external verifiers can also slow down the credit approval process, discouraging the use of specific funding lines.

- asymmetric composition of the EU Member states' business sectors. Countries characterised by a higher concentration of SMEs face particularly difficult challenges in pursuing sustainable investments. Verifying taxonomy compliance of activities and/or investment often involves burdensome processes for SMEs and start-ups. In this context, regulation should well balance the data requested from different companies. While start-ups and SMEs have the potential to be a major driver of innovation for sustainable development, further attention should be given to their financial needs to support the "brown" companies in their transition to more sustainable business models.
- public authorities and financial institutions should cooperate to identify mechanisms for complementing traditional sources of credit for SMEs operating in green sectors with more sophisticated financial instruments that allow a longer-term view. Emerging solutions to be considered could include fintech, crowdfunding for sustainable projects and impact finance.
- potential synergies have not yet been explored in sustainable finance, such as that of a supply chain approach. The approach may allow for integration of opportunities and environmental risk analysis along the whole value chain.
- There should be synergies between economic policies and technology investments as the EU Commission has with the IPCEI framework (for instance on electrolysis storage).
- Green-washing has been a crucial barrier so far, the EU Taxonomy should be a helpful instrument in prevention.
- Limited customer demand (though growing but still not mainstream)

Also see our answer to Question 60 and to additional comments relevant to securitisation transactions in a separate paper **AFME response to EC on Renewed Sustainable Finance (Green Securitisation) 15 July 2020**.

Question 67: In your view, to what extent would potential public incentives for issuers and lenders boost the market for sustainable investments?

- Please express your view on the importance of financial incentives by using a scale of 1 (not effective at all) to 5 (very effective).
- In case you see a strong need for public incentives (scores of 4 to 5), which specific incentive(s) would support the issuance of which sustainable financial assets, in your view? Please rank their effectiveness using a scale of 1 (not effective at all) to 5 (very effective).

Types of incentives	Bonds	Loans	Equity	Other
Revenue-neutral subsidies for issuers	5			
De-risking mechanisms such as guarantees and blended financing instruments at EU-level	5	5	5	
Technical Assistance	5	5	5	
Any other public sector incentives - Please specify in the box below.				4

- Please specify the reasons for your answer (provide if possible, links to quantitative evidence) and

add any other incentives you would like the Commission to consider. [BOX max. 2000 characters]
5- Very Effective It would be important to have public incentives up to when the cost of funding through sustainable instruments offsets the administrative cost/burden associated with the selection and/or verification of the sustainable investments realised by the borrower/issuer. Other potential incentives could include: • Technical Assistance: the set-up of a consultation and technical support service, aimed to help banks in defining exhaustive and achievable metrics for sustainable finance, would be essential to overcome know-how gaps affecting this sector and would foster sustainable investments. The sharing of specific know-how within the EU is considered fundamental; such process may be supported through dedicated EU funded training initiatives addressed to banking sector professionals. • Tax incentives: tax incentives for companies seeking green or transition financing, could have a significant stimulating effect. Also, the introduction of a tax incentive mechanism for IT investments in the set-up of ESG data management framework could be useful for the achievement of sustainability objectives. Such incentives could be linked to the adoption of robust transition strategies. • IPCEI strategic guidelines should be a key point to lead transition towards clean energy sources. Considering investments in electrolysis could be a way to foster this transition. Some suggestions could include: i) a carbon tax on CO2 emissions and incentives for CO2 seizure, ii) Regulatory asset base (RAB) remuneration based for investments in electrolysis plants, iii) incentives for Mm&A of TSO managing gas and electricity. • Monitoring companies' carbon footprint could be the way to anchor incentives (e.g. ad hoc VAT) and allow access to more efficient financial instruments and platforms. • Availability of de-risking mechanisms for both lending and bond issuance, including guarantee and risk-sharing instruments provided by the EIB Group and other development finance public institutions, would increase the lending capacity of commercial banks to provide further financing for sustainable activities. Please refer to additional comments relevant to securitisation transactions in a separate paper **AFME response to EC on Renewed Sustainable Finance (Green Securitisation) 15 July 2020**.
Question 68: In your view, to what extent would potential incentives <u>for investors</u> (including retail investors) help create an attractive market for sustainable investments? • Please express your view by using a scale of 1 (not effective at all) to 5 (very effective). 5- Very effective • For scores of 4 to 5, in case you see a strong need for incentives for investors, which specific incentive(s) would best support an increase in sustainable investments? [drop down menu] ○ Revenue-neutral public sector incentives ○ Adjusted prudential treatment ○ **Public guarantee or co-financing** ○ **Other**

- Please specify the reasons for your answer (provide if possible, links to quantitative evidence) and the category of investor to whom it should be addressed (retail, professional, institutional, other). [BOX max. 2000 characters]

We believe that tax benefits for investments in sustainable products would be an effective tool in promoting such investments. AFME would support a creation of a specific European Sustainable Finance Guarantee Fund aimed at providing guarantees to financial institutions (private banks or medium/long term investors such as funds or insurance companies) to support sustainable lending and investments, thus increasing additional sources for these projects as opposed to substituting existing lending sources with cheaper funding for the ultimate beneficiaries (i.e. SMEs and MidCaps).

Additionally, we would suggest that guaranteed green bonds are offered to retail.

Please refer to additional comments relevant to securitisation transactions in a separate paper **AFME response to EC on Renewed Sustainable Finance (Green Securitisation) 15 July 2020**.

Question 69: In your view, should the EU consider putting in place specific incentives that are aimed at facilitating access to finance for SMEs carrying out sustainable activities or those SMEs that wish to transition?

- **Yes**/No/Do not know.
- If yes, what would be your main three suggestions for actions the EU should prioritise to address this issue? [box max. 2000 characters]

SMEs that seek access to green finance continue to face significant barriers in terms of interest rates, provision of medium- and long-term tenors and collateral requirements. Measures could include:

- stable and transparent direct policy incentives that improve the risk-return profile of low carbon sustainable activities, especially tax-based stimuli, are often effective tools as they allow commercial banks and private business respond by creating innovative business models that leverage those incentives.
- development of a specific credit guarantee facilities managed by the EIB Group and other development finance institutions to stimulate SME green lending and leasing, as SMEs usually do not hold enough collateral and are perceived as riskier.
- a dedicated platform to allow SMEs to access technical assistance services by ESG experts which also implicitly could decrease the costs related to these services. Grant-funded technical assistance to support financial intermediaries with project preparation, capacity building (marketing, staff training, awareness workshops with customers, etc.), and monitoring, and support prospective SME borrowers in identifying priority investments through, for example, energy audits and best-performing technologies.
- definition of guidelines and/or general “green covenants” for sustainable loans granted to SMEs - possibly differentiated based on the sector/ industry the counterparties belong to (e.g. definition of "positive covenants" or contractual clauses providing benefits for counterparties that achieve the expected sustainability objectives).

Please refer to additional comments relevant to securitisation transactions in a separate paper **AFME response to EC on Renewed Sustainable Finance (Green Securitisation) 15 July 2020**.

1.1 PROMOTING INTRA-EU CROSS-BORDER SUSTAINABLE INVESTMENTS

Question 74: Do you consider that targeted investment promotion services could support the scaling up of cross-border sustainable investments?

- **Yes**/No/Do not know.
- If yes, please specify what type of services would be useful for this purpose:
  - **Information on legal frameworks**
  - **Individualised advice (e.g. on financing)**
  - Partner and location search
  - **Support in completing authorisations**
  - Problem-solving mechanisms
  - **Other, please specify [box max. 2000 characters]**

- Prioritising objectives and targets and directing investments to the higher priorities
- Engaging with various stakeholders of involved countries to enhance the transparency level and facilitate the monitoring around sustainable investing

1.2 EU INVESTMENT PROTECTION FRAMEWORK

Question 75: Do you consider that the investment protection framework has an impact on decisions to engage in cross-border sustainable investment? Please choose one of the following:

- Investment protection has no impact.
- Investment protection has a small impact (one of many factors to consider).
- Investment protection has medium impact (e.g. it can lead to an increase in costs).
- **Investment protection has a significant impact (e.g. influence on scale or type of investment).**
- Investment protection is a factor that can have a decisive impact on cross-border investments decisions and can result in cancellation of planned or withdrawal of existing investments.
- Do not know.

1.3 PROMOTING SUSTAINABLE FINANCE GLOBALLY

Question 76: Do you think the current level of global coordination between public actors for sustainable finance is sufficient to promote sustainable finance globally as well as to ensure coherent frameworks and action to deliver on the Paris Agreement and/or the UN Sustainable Development Goals (SDGs)?

- Please express your view by using a scale of 1 (highly insufficient) to 5 (fully sufficient).
- For scores of 1-2, what are the main missing factors at international level to further promote sustainable finance globally and to ensure coherent frameworks and actions? [BOX max. 2000 characters]

2 - Rather insufficient

AFME would encourage further global coordination. Concerning climate risk, we would particularly welcome international standard setters to actively engage with the new IOSCO Task Force on Sustainable Finance and Basel Committee Task Force on Climate-related Financial Risk. Further activity is taking place in bodies such as the Financial Stability Board (FSB) or the institutions comprising the international financial architecture (for instance, the International Monetary Fund). Discussions among peers in efforts such as NGFS and the new EU sponsored International Platform for Sustainable Finance

(IPSF) are considered useful platforms for exchanging best practice and foster global harmonisation, despite the latter initiatives lacking legal standard setting mandates.

In order to ensure coherent and harmonised global action, we believe that the sustainability agenda could benefit from a coordination effort via the G20 / FSB similar to the post 2008 financial crisis regulatory response.

It should be noted that some key jurisdictions that will be essential to achieving aligned frameworks have been largely absent from the still-emerging global policy and standard setting discussions. The European Commission's work to create the IPSF is important but needs to be approached with the acknowledgement that certain jurisdictions will need more time to make progress in their regions.

Question 77: What can the Commission do to facilitate global coordination of the private sector (financial and non-financial) in order to deliver on the goals of the Paris Agreement and/or SDGs? Please list a maximum of three proposals.

- [BOX max. 2000 characters]

We would encourage the Commission to continue to closely monitor private-public sector initiatives to further analyse industry best practices. It is important to establish the role that financial institutions play in real economy (e.g. energy) / sustainable finance transition. Their contributions will vary based on where the specific opportunities and risks in the markets they operate.

For jurisdiction specific proposals on policy and regulatory reform to be effective, it is important that global standard setters agree on a minimum set of standards, definitions and scenarios related to the global real economy transition and related financial risks. This framework can help regional policy, supervisory and regulatory efforts as well as the industry stakeholders operating in those jurisdictions.

Also see our comments to Question 76

Question 78: In your view, what are the main barriers private investors face when financing sustainable projects and activities in emerging markets and/or developing economies? Please select all that apply.

- **Lack of internationally comparable sustainable finance frameworks (standards, taxonomies, disclosure, etc.);**
- **Lack of clearly identifiable sustainable projects on the ground;**
- **Excessive (perceived or real) investment risk;**
- **Difficulties to measure sustainable project achievements over time;**
- **Other, please specify [BOX max. 2000 characters].**

Some of the risks that act as disincentives to private sector investment relate to policy and regulatory uncertainty; market volatility such as currency fluctuations; and political and legal risks and uncertainties.

For example, the need for most sustainable investment is in parts of the world where credit risk is high (resulting in sub-investment grade financing), meaning many long-term providers of capital, such as pension funds, cannot invest there.

Some differentiation will be necessary between investment grade and high-yield investment instruments. Development banks will need to build capability to provide capital that is genuinely catalytic in the capital structure. Specifically, there will need to be first-loss (grant) layers/ concessional debt provided to help de-risk investment and thus adjust IRRs.

Additionally:

1. In spite of the massive investment need in emerging markets and/ or developing countries, the scale of investment is often low and needs to be increased by bundling together individual projects.

2. Emerging markets and/ or developing economies have very often less stringent environmental and social regulations requiring complementary diligence to ensure that minimum standards/ positive impacts are met.

3. Similarly, these countries often lack a quality (regulatory) reporting and verification framework that fosters the necessary transparency of sustainable finance markets.

4. The identification of sustainable projects is more difficult in emerging markets and/ or developing countries. This would require, in particular, evaluating and monitoring the positive impacts of the projects through additional studies. These studies would have to be carried out upstream of the financing process and represent an additional cost, which raises the point of how these costs should be allocated.

5. Furthermore, "E" and "S" assessments - when carried out - focus today on identifying and managing the negative impacts of projects, rather than on the positive sustainability benefits. The assessment of these benefits should be integrated from the outset in "E" and "S" assessments to be able to assess the alignment of projects with, for example, the EU Taxonomy.

See also our response to Question 79.

Question 79: In your opinion, in the context of European international cooperation and development policy, how can the EU best support the mobilisation of international and domestic private investors to finance sustainable projects and activities in emerging markets and developing countries, whilst avoiding market distortions?

- Please provide a maximum of three proposals. [BOX max. 2000 characters]

For developing countries, public funding will be insufficient for financing SDGs. Crowding in private sources of funding will be critical for meaningful progress in the areas of health, education, roads and transportation, electricity, water and sanitation. Support from the EU should aim to address a series of market and government obstacles in attracting private investment to sustainable infrastructure projects in developing countries, specifically:

- a lack of bankable projects for investment;
- high upfront costs of project development;
- a shortage of long-term FX debt;
- a lack of local currency debt; and
- inadequate capacity and expertise in public and private sectors in some of the world's poorest countries.

Absence of deep capital markets in emerging and developing countries makes them more dependent on bank loans for infrastructure financing. A large portion of that financing is cross-border, reflecting greater dependence on foreign sources of capital, and a significant part is provided in USD. However, there is a limited capacity to hedge currency risk linked to projects that generate cash flows in local currency, creating disincentives for infrastructure investments in those markets. The development of capital markets and the availability of facilities that hedge currency risk or provide access to local currency would enable a new pool of capital to be unlocked for infrastructure projects. Further, availability of de-risking instruments for commercial banks would help increase their borrowing limits on large international sponsors, which are often the most suited enablers to develop and finance, for instance, large renewable energy and sustainable infrastructure projects in emerging and developing economies.

There is a need for a strong, well-coordinated policy around providing subsidies by the EIB, EBRD and the IBRD to developing markets. It would be important to leverage the capability of the EIB and the EBRD to blend both private and public financial sources at EU-level to help overcome barriers to investment by providing long-term financing to less developed countries, introducing de-risking mechanisms and working with a network of international and local commercial banks on implementing financing packages in support of energy efficiency and renewable energy projects. A greater flexibility on the standard Loss-of-Rating clauses adapted to the reality of developing countries could expand the capacity for on-lending through partner banks.

To increase the capacity of investment funds directing capital to sustainable sectors and projects in emerging markets, partnerships between different external and internal sources of development finance can be beneficial. The EU could promote and offer such partnerships which are not only about financing but also related to sharing technological capabilities, managerial and professional skills or knowledge/know-how.

Additionally, measures that the EU can take include:

- there is a need for better policy coordination between the EC Directorates spearheading mobilisation and those responsible for financial supervision/regulation.
- Some multilateral development banks currently fund preliminary studies for projects before financing them. The EU could set up a body to finance preliminary studies on the sustainability of projects to be financed by the private sector.
- In the export context, European Export Credit Agencies (ECAs) could - within the OECD consensus - grant more favorable terms to transactions qualified as sustainable. If the OECD arrangement on officially supported Export Credits were amended, it could take into consideration sustainability criteria to grant better financing terms to further encourage such sustainable transactions.

Question 80: How can EU sustainable finance tools (e.g. taxonomy, benchmarks, disclosure requirements) be used to help scale up the financing of sustainable projects and activities in emerging markets and/or developing economies? Which tools are best- suited to help increase financial flows towards and within these countries and what challenges can you identify when implementing them? Please select among the following options.

- All EU sustainable finance tools are already suitable and can be applied to emerging markets and/or developing economies without any change.
- Some tools can be applied, but not all of them. If necessary, please explain [box max. 2000 characters].
- **These tools need to be adapted to local specificities in emerging markets and/or developing economies. Please explain how you think they could be adapted [box max. 2000 characters].**
- Do not know.

These tools are specific, tailored additions to the existing body of European laws, policies and regulations that govern ESG issues. Many emerging markets/ developing economies are unlikely to have the same strong base/foundations, which will make adopting them significantly harder.

Imposing such requirements *en masse* without any adaptation, would be ineffective due to their sophistication and complexity.

Ensuring simplification and clarity of these tools and ensuring their associated costs are not onerous are likely to be key to their adoption in recipient countries.

To date, it is already a requirement to conduct E&S assessments based on recognised standards such as the Equator Principles, the IFC Performance Standards, and the WBG EHS Guidelines. These frameworks are widely recognised by global markets, therefore it would be important to build on such existing standards as a first step and then seek to further harmonise international rules and guidelines considering the EU sustainable finance measures.

In this sense, the EU Taxonomy could be adapted to integrate existing practices and thus constitute a a common reference for all investing/lending institutions and investees/borrowers capturing practical experience of the use of the taxonomy. We think that the International Platform on Sustainable Finance can play an important role in helping to integrate the EU sustainable finance tools into existing international practices adopted by emerging markets and/or developing economies.

3. REDUCING AND MANAGING CLIMATE AND ENVIRONMENTAL RISKS

3.1 IDENTIFYING EXPOSURES TO HARMFUL ACTIVITIES AND ASSETS AND DISINCENTIVISING ENVIRONMENTALLY HARMFUL INVESTMENTS

Question 82: In particular, do you think that existing actions need to be complemented by the development of a taxonomy for economic activities that are most exposed to the transition due to their current negative environmental impacts (the so-called "brown taxonomy") at EU level, in line with the review clause of the political agreement on the Taxonomy Regulation?

- Yes/**No**/Do not know.
- If no, please explain why you disagree [BOX max. 2000 characters]
- If yes, what would be the purpose of such a brown taxonomy? (select all that apply)
  - Help supervisors to identify and manage climate and environmental risks.
  - Create new prudential tools, such as for exposures to carbon-intensive industries.
  - Make it easier for investors and financial institutions to voluntarily lower their exposure to these activities.
  - Identify and stop environmentally harmful subsidies.
  - Other, please specify. [box max. 2000 characters]

Overall, we consider that, developing an exhaustive, all-encompassing taxonomy covering all economic activities (as further suggested by Question 83) is not feasible. Moreover, attempting to develop such exhaustive list will only create unnecessary investment uncertainty and complexity for activities that do not fall under the Taxonomy classification.

Whilst we fully support a framework improving reporting and disclosure around carbon intensive sectors, including those that cannot change their business models, we think that creating a detailed "brown" taxonomy would be premature and might have unintended negative consequences discouraging investments in those sectors/activities, ultimately hampering the needed transition. As noted in our response to Question 9, AFME believes that EU policymakers should instead focus on establishing clear industrial transition pathways for a measured and gradual reduction in GHG emissions towards the 2050 goal. We provide our further considerations on this matter below.

First, we believe that the top priority for the Commission should be to finalise the Green Taxonomy and assess its effectiveness in supporting the redirection of financial flows towards sustainable activities, as well as assess if any gaps/issues exist, before deciding to develop a brown, or any other, taxonomy.

Second, the potential scope of what such a brown taxonomy could cover would have to be carefully considered. We see a growing need to be able to identify exposures to sectors/activities that are most exposed to environmental risks (both physical and transition risks) but it is important to distinguish between those sectors/activities that can transition towards the sustainability objectives and those that cannot. For the latter, there may be merit in a classification which identifies harmful sectors/activities that do not have the capability for transition (similar to "solid fossil fuels" as defined in the taxonomy level 1 framework), which would give a clear indication of the transition risk, depending on how such a classification is developed. However, for those harmful sectors/activities having potential to transition towards a sustainable economy, setting out clear transition pathways as outlined in our response to Question 9 would be more informative and therefore effective than a static brown/green classification to mobilise capital for green and transition investments. Such a dynamic approach would provide much-needed guidance to "brown" industries looking for transition strategies with clear milestones as well for investors seeking to understand the transition performance of the investees against established trajectories.

Most importantly, we caution against the development of a brown "asset-tagging" taxonomy under the same approach as for the green taxonomy as this may have the unintended consequences of discouraging investment into companies and/or assets operating in "brown" industries that are willing and able to transition. An abrupt divestment from such companies would ultimately hamper the transition.

Additionally, any potential application of such a "brown" taxonomy to the banking prudential framework (e.g. brown penalising factors) should await the completion of the EBA's mandate on the prudential treatment of green/brown assets and potential international standards. In this context, a better understanding of the extent to which banks' exposures to different sectors/activities are already captured in banks' models is important. This needs to be based on common scenarios and disclosures that inform risk managers how these assets will perform.

Nevertheless, we recognise that there is a need for providing better transparency/reporting to investors around the sectors/activities that require transition. We think that identifying such sectors can and should be based on the existing frameworks, such as TCFD definition of carbon intensive sectors; the UNEP FI pilot to develop a list of climate sensitives sectors; and PATCA methodology for identifying climate relevant sectors and activities for alignment analysis. We note that this exercise should not fall within the existing taxonomy framework which was developed with a very different end-use in mind (incentivising green investment and preventing green washing). To promote better transparency the EC should ensure it:

i) Sets out comparable disclosure & transparency requirements on data, which would facilitate systematic and efficient data sharing and reporting by the companies and likewise support the development of data collection and analysis by the financial sector.

ii) Permits fully risk-based decision-making in financing decisions, i.e. not artificially penalising specific sectors

Finally, we would note that subsidies for fossil fuels and other environmentally harmful activities can be removed without defining a comprehensive, granular taxonomy (i.e. existing guidelines noted above can already be used for this purpose).

Question 83: Beyond a sustainable and a brown taxonomy, do you see the need for a taxonomy which would cover all other economic activities that lie in between the two ends of the spectrum, and which may have a more limited negative or positive impact, in line with the review clause of the political agreement on the Taxonomy Regulation?

- Yes**/No/**Do not know.
- If yes, what should be the purpose of such a taxonomy? Please specify. [BOX max. 2000 characters]

Additoinal comment:
As mentioned in our response to Question 82, we consider that attempting to establish an exhaustive all-encompassing taxonomy covering all economic activities is not feasible, and may introduce unnecessary investment complexity and uncertainty for non-classified activities.

Moreover, we do not believe the resources required for the development of an exhaustive, granular taxonomy covering all economic activities would be proportionate to and able to efficiently deliver on its end goal of stimulating investment in green and transition activities. Hence, we do not support the development of such a taxonomy for all other economic activities lying in between the green and brown ends of the spectrum.

3.2 FINANCIAL STABILITY RISK

Question 84: Climate change will impact financial stability through two main channels: physical risks, related to damages from climate-related events, and transition risks, related to the effect of mitigation strategies, especially if these are adopted late and abruptly. In addition, second-order effects (for instance the impact of climate change on real estate prices) can further weaken the whole financial system. What are in your view the most important channels through which climate change will affect your industry? Please provide links to quantitative analysis when available.

- **Physical risks, please specify if necessary [BOX max. 2000 characters]**
- **Transition risks, please specify if necessary [BOX max. 2000 characters]**
- **Second-order effects, please specify if necessary [BOX max. 2000 characters]**
- Other, please specify [BOX max. 2000 characters]

There are major challenges with how to consider how both transition and physical risks affect our clients. Nonetheless, AFME considers that transition risk is the primary channel to which the banking industry is exposed and should be addressed in policy action. This should be aimed at providing policy certainty for banks to start to develop scenarios and models based on the financial impact on their portfolios. Physical risks can be extreme in certain scenarios but generally occur further out in time than transition risk.

We would also highlight the important role of stress tests in understanding the impact on financial stability and second order effects. To some extent these are already considered in EBA stress test exercises – e.g. testing a 20% drop in real estate prices, however, while it may not be specified that such a drop is due to climate risk specifically the outcome may be the same. It is important that regulators take this into account and avoid double counting of second order impacts in stress tests. We also welcome the NGFS work on developing scenarios, which will be crucial to understanding the impact of transition and physical risks.

Transition risks:

We expect the impact of this will be evident in the near future for credit risk portfolios and will affect the financial stability of some companies dependent on their geography e.g. if the region's economy is heavily skewed towards those that are effected by transition such as automotive and energy sectors. Indeed, the sectors concerned by transition risks are *a priori* the most carbon intensive sectors as of today and have already been identified, hence the possible measures impacting those sectors to align them with a Paris objective target can already be factored in. As a result, it will be easier to implement a risk management strategy to manage them and lower their impacts. Nonetheless, given that transition risks are based on country specific policy change, such risks could be hard to model in some instances, because they require dynamic political assessments. Moreover, although transition risks are based on country specific changes, they will vary within and across industries and the companies exposed to those sectors e.g. if an oil company has exposure to a variety of fields with differing extraction costs then the transition risk will vary.

Physical risks:

Physical risks will have a major impact over a longer timeframe and will include not only damages from climate related events, but also second order effects. Again, this could in some cases be less relevant to banks who are focused on financing regions that will be less impacted by climate change than other parts of the world such as central and eastern Europe vs. India or Netherlands, but these banks should also be mindful of second order effects resulting for instance from exposures to their counterparties outside these regions.

Second-order effects:

The combination of physical and transition risks will have repercussions on a bank's portfolio that will depend on its composition in terms of business sectors, geographies and characteristics of the counterparties (e.g. supply chains, technology in use, business model). Banks will be primarily impacted through the impacts of climate change on their client's business model, which could lead (in case of negative impact) to an increase of both their probability of and loss given default.

Question 85: What key actions taken in your industry do you consider to be relevant and impactful to enhance the management of climate and environment related risks?

- Please identify a maximum of three actions taken in your industry [BOX max. 2000 characters]

Enhancing the management of climate and environmental risks is a joint and evolving process between regulators, institutions and related stakeholders and clients. For the banking industry climate risk is not necessarily seen as a separate risk type, but as a driver for or an amplifier of existing risks such as credit risk. Systematic assessment of climate related risks and implementation in the risk management frameworks is key, and industry and relevant authorities are in the process of developing methods to do this. To get to this point we consider that the three most important actions which are a work in progress in conjunction with stakeholders are as follows:

Disclosure:

It is essential to enhance the quality and consistency of climate risk-related disclosures, especially for investors. In this respect TCFD based disclosure is useful to further understand financial firms' governance, strategies, risk management, and metrics and targets related to climate risk. Here we note that financial sector disclosures (investors, lenders, or insurers) have a clear dependency on real-economy company disclosures. Consequently, the demands and expectations put on the financial sector must reflect at any point in time the current state of non -financial disclosures. It will also be important to agree on a common methodology to monitor indirect GHG emissions. Additionally, we consider that bank disclosures should be made at parent level for both EU and international banks - this will allow investors to have the appropriate information at the decision-making level.

We also note that industry welcomes the NFRD review to support disclosure, and separately we will be responding to the ECB consultation on their climate risk guide which also includes disclosure requirements.

Risk management:

Incorporating climate risk into the risk management framework of a bank is still at an early stage of development and will require engaging actively with the most exposed clients and promoting a transition towards more sustainable business models. To achieve this banks are looking to coordinate decisions to adopt green lending policies, phasing out/ or limiting the corporate financing of most carbon intensive economic activities (e.g., Coal Fuel fired Generation Assets/Non-conventional Oil/Gas exploration and production projects), alongside fostering corporate financing towards sustainable economic activities (e.g. development of renewables asset construction). Banks are also increasing the offer of sustainable products to their customers and developing internal methodologies for the impact calculation, from an internal institutional point of view. For example, banks are looking at product development that will incentivise clients to invest in ESG, expand and grow their green finance portfolio through new instruments, in particular transition bonds, structured products and via green-linked opportunities outside the formal green markets (e.g. carbon trading), as well as green mortgages. Nonetheless, care must be taken to ensure that the investment criteria applied to ESG products are robust in relation to their underlying fundamentals rather than simply the label attached to them.

Banks are working to guarantee adequate resources and sufficient skills and expertise to dedicate to developing and managing the financial risks related to climate risks. Where climate risks are incorporated into risk appetite and strategy, the ownership of 'climate' risk is usually defined via sustainability functions, although we increasingly see it moving to risk functions which is a positive development. Senior management committees also play a role in revising policies to include more stringent criteria. Risk management functions are starting to evaluate climate risks via the more precise identification of climate impacted clients and via the creation of client CO2 mapping/databases. For example, with respect to market risks, these are being evaluated to refine the monitoring of their exposure via more specific limits linked to products such as commodities which are primarily exposed to the large price fluctuations as a result of major climate events.

To meet the need to better incorporate climate risk into risk management, Members consider it would be helpful to have an aligned set of climate and environmental risk management standards, rather than the developing patchwork (e.g. BaFIN Sustainability Risk Management Guidelines, DNB Good Practice for Integration of Climate-related risks into Risk Management). In this respect the ECB guidelines for climate risk may be a useful tool, though we recommend the implementation of the guide should be done in a coordinated manner with other climate risk management initiatives (such as the timeframe for implementing the EBA guidelines on loan origination and monitoring). We also support work being taken at the international level via the Basel Committee to consider this.

Stress-testing:

Climate risk and scenario analysis are new tools being actively developed by the industry and regulators to understand potential financial risks. Banks are in a period of research and development in relation to scenario analysis and stress testing and continuing to learn and fill in data gaps. Supervisory expectations do – and should continue to – reflect this. For instance, some of AFME's members have participated in an initial UNEP-FI TCFD pilot project from which a lot has been learnt. However, while the techniques have been tested over last 3-5 years, banks do not yet have the confidence intervals or reasonable error ranges and more data is needed to understand the climate risk inputs. There are also significant challenges with modelling physical and transition risk within long-duration funding (15-20 year funding structures) because the disclosures are short-term – while banks know there are "risk cliffs" they are not yet in a position to appropriately and prudently disclose or model. Essentially the challenge banks face is that the time horizon of climate risk is mismatched to the time horizon of most banks' lending portfolios. It is also important to actively engage clients on the transition and not just focus on risk policies and scenario analyses, as the changes required to integrate climate risk management will impact clients' cost of funding and business models.

Question 86: Following the financial crisis, the EU has developed several macro- prudential instruments, in particular for the banking sector (CRR/CRDIV), which aim to address systemic risk in the financial system. Do you consider the current macro- prudential policy toolbox for the EU financial sector sufficient to identify and address potential systemic financial stability risks related to climate change?

- Please express your view by using a scale of 1 (highly inadequate) to 5 (fully sufficient).
- For scores of 1-2, what solution would you propose? Please list a maximum of three. [BOX max 2000 characters]

Rather sufficient- 4.

Additional comment:

Overall prudential regulation has sufficient buffers to manage events that threaten financial stability. For example, if the impact of climate change were to emerge in the same way as COVID-19 (i.e. in a sudden and unexpected manner and having a significant impact), we consider the current macroprudential toolbox would be largely sufficient to address it.

While there is room for improvement, for example for making the toolbox more consistent, we think the current framework is fit for purpose. The existing tools offer sufficient flexibility to address drivers of systemic risks one by one, this will include climate risk as banks move to integrate it into the existing risk management framework. Nonetheless if the EU did decide to take further action, one area of development could be a common framework for supervisors to set out how the existing macro-prudential tools should be used to address climate and / or environment risk.

For instance, as noted in Question 85, we consider that climate risk is a potential magnifier of existing risk types, consequently we do not think this should be a risk type per se which should lead to the application of risk buffers such as the systemic risk buffer. Therefore, one area where more could be done to drive better consistency would be the use of buffers to ensure a consistent approach across jurisdictions (within the EU and internationally).

Banking prudential framework

Question 88: Do you consider that there is a need to incorporate ESG risks into prudential regulation in a more effective and faster manner, while ensuring a level- playing field?

- Yes/No/Do not know.
- If yes, is there any category of assets that could warrant a more risk-sensitive treatment? Are there any other prudential measures that could help promoting in a prudentially sound way the role of the EU banking sector in funding the transition to a more sustainable economy? [box max. 2000 characters]

We recognise the climate emergency and ambition of the EU institutions, not least to support a green recovery from the COVID-crisis. In light of this we support the Commission exploring how to better incorporate ESG risks into the prudential framework, while ensuring that this is based on coherent and consistent standardization of risk management processes, disclosure, and risk analysis.

With regard to specific prudential measures aimed at sustainable finance there is a need for EU wide, and ideally international standards. In this respect, the work of the NGFS on the management of climate related and environmental risks is very important to avoid differences emerging in scenario analysis exercise, design and requirements, as well as the output of the Basel Committee Taskforce on Climate-related risks.

Below we set out our views on the key regulatory initiatives underway to incorporate ESG into the prudential framework:

Prudential treatment of Green/Brown assets: The EBA plans to publish a discussion paper for consultation (2021) and then produce a final report by 2025 at the latest. We understand as part of this the EBA is considering a QIS and using the current EU taxonomy framework. Several of our members are also participating in the Pilot Sensitivity Exercise on Climate Risk, which was launched in May, aimed at performing a preliminary assessment on banks exposures. Overall, we are open to working faster on the possible adaptation of prudential policy related tothe treatment of green and brown assets if the EBA chooses to come forward sooner than 2025, however, banks should be given suitable time to implement any changes.

More important than the time frame is the approach - in particular, industry is concerned by the way in which the EBA may choose to apply the taxonomy as the level of detail it entails will be challenging to be incorporated directly in the prudential framework. For instance the taxonomy may not fully take into account the dynamic strategy of a corporate, whereby, all things being equal, the business model of a client which develops, adopts and implements a robust transition strategy is expected to be more resilient than that of a client which does not proactively manage its transition risk. The nature of loan may also raise challenges depending on whether it is a single purpose or general loan. Whilst the classification of single purpose loans for the financing of an identifiable physical asset or activity will be clear, loans for general corporate purposes have a weaker direct link to a physical asset or a project and would therefore be more difficult to classify under the EU Taxonomy framework. The EBA will also need to be mindful of how it uses data emanating from 2020 given the impact of COVID-19 which could limit its ability to develop this area.

Furthermore, industry is generally extremely cautious on how green/brown assessments should be incorporated into assessing the risk of prudential assets. Some of this concern is already reflected in the report of the NGFS on financial institutions' practices with respect to introducing risk differentials between green, non-green and brown financial assets. This report found no strong conclusions on a risk differential between green and brown on the institutions they surveyed. In respect of a green supporting or brown penalising factor, the report highlighted the risk of double counting and distorting the Level 1 risk assessment of assets through the introduction of green/brown factors. This report also recognised the need for a review of international standards to introduce any changes to the Pillar 1 framework.

As per this report, AFME considers that any specific treatment distinguishing between 'green' or 'brown' assets needs to be consistent with the principles of traditional prudential regulation and should be agreed at an international level where possible. We also note that supervisors can address transition and physical risk through stress-tests, ICAAP and the Pillar 2 framework. While we support adapting prudential policy to better consider 'green' and 'brown' this should use balanced, logical, quantitative constructs, based on observation and scientific data. In the current absence of evidence of a risk differential between green, non-green and brown assets, the EC should encourage the development – ideally at international level – of risk assessment methodologies that include a forward-looking perspective in addition to existing backward-looking analysis, to enable a more accurate calibration of regulatory capital requirements reflecting the long term risk profile of assets. Differentiating between brown and green assets should not be based on a static classification of economic activities established by the taxonomy but done in a dynamic forward-looking risk-oriented way. In other words, the classification of an asset under the taxonomy should not be a proxy for its risk profile, nor lead to automatic risk weighting adjustment, particularly given that loss severity and transition risk is going to be constantly evolving.

The primary objective should be for the EU to move towards a climate risk management structure based on common frameworks, lexicons, taxonomies, statistics, scenarios and experience and underlying loss norms before moving towards capital allocations. Indeed, as set out in Question 82, a brown taxonomy in the same vein as the green taxonomy framework under development presents an inherent definitional challenge as currently the majority of economic activities are probably generating some level of pollution and need to transition. With regard to green loans, the prudential treatment could also be linked to green loan standards and underlying risk as referenced in the ECB opinion, rather than using a green or brown taxonomy.

Incorporation of ESG factors in the SREP: This includes consideration of strategy and risk management, key metrics and disclosure, stress-testing and scenario analysis, and prudential treatment. To promote international convergence of practices, we consider any changes made by the EBA to SREP should be as consistent as possible with the NGFS Guide for Supervisors on integrating climate-related and environmental risks into prudential supervision and development of scenario analysis. The EBA and the ECB should also work closely to ensure that the ECB supervisory guide and SREP are consistent and published in coordination with each other to avoid overlapping requirements that could increase the burden of implementation. We look forward to responding to the EBA's discussion paper over 2020/2021.

Disclosure: As part of the EBA's mandate on Pillar 3, the EBA will develop uniform disclosure requirements that will be applicable as of June 2022. We support the approach the EBA has indicated to ESG-related disclosure, which is meant to build on existing regulatory products. We welcome a pragmatic approach, taking into account the value of existing disclosures or already available data in order to avoid any duplication and unnecessary operational burden.

Stress testing and scenario analysis. The EU-wide stress-testing exercise was postponed during this COVID-19 crisis period, while a climate risk stress test exercise was maintained by the EBA on a voluntary basis. This sensitivity analysis for climate risk was adapted in scope and methodology to reduce the burden for institutions. We understand that at a later stage, the EBA plans to provide guidance to banks and supervisors regarding banks' own stress testing as part of a report. Qualitative and quantitative criteria to assess the impact of ESG risks under scenarios with different severities will be explored. Following on from that report, the EBA may update relevant guidelines related to risk management and stress testing. We also take note of the draft ECB guide to climate-risk which expects institutions with material climate-related and environmental risks to evaluate the appropriateness of their stress testing with a view to incorporating them into their baseline and adverse scenarios as part of their ICAAP exercise (albeit with a longer forward looking time-horizon), as well as considering them in recovery planning.

We recommend that the EBA and ECB exercises be kept relatively simple to ensure proportionate effort and relevant outcomes for risk management to make use of. Overall it seems reasonable to calibrate existing model inputs to reflect climate-related factors for the assessment of short term impacts of climate risk, but for long term impacts it is important to develop specific climate scenarios and methods that consider the evolution of climate factors over decades (we welcome the work of the NGFS on this which will help drive consistency and we will review it in due course). One way of achieving this could be a flexible approach to climate risk in line with the BaFin expectations which states: 'Supervised entities should check whether the existing internal stress tests adequately reflect the material sustainability risks, or if new or modified internal stress tests should be created to address these'. We would also emphasise the importance of avoiding double counting of climate risks (see also Q84 and Q85).

EBA guidelines on loan origination and monitoring: From June 2021 loans originated to micro, small, medium and large enterprises will need to consider ESG risks. We consider finalisation of these guidelines in respect of ESG to be a proportionate and welcome first step though further review may be needed once operationalised.

Question 89: Beyond prudential regulation, do you consider that the EU should take further action to mobilise banks to finance the transition and manage climate-related and environmental risks?

- Yes one or both, please specify which action would be relevant [BOX max. 2000 characters]
- **No.**
- Do not know.

Additional comment:

Prudential policy should not be the primary policy tool to green the whole economy. Overall, appropriate prudential regulation will ensure risks are sufficiently taken account of. Using the capital framework as a policy mechanism to change other actors' behaviour is problematic if banks are relied upon the primary driver for what are ultimately political decisions. While there are parts of the economy that will pollute, foundational parts of the economy still need financing: infra, power, energy – the goal is to incentivise transition. Banks should not be directed to lend or otherwise have targets similar to what occurs in other jurisdictions (e.g. Community Reinvestment Act in US).

Moreover, we support an EU approach which looks beyond primary regulation, and which focuses on the development of convergence on common methodologies and standards (e.g. SBTi, TCFD,) as well as helping to fill data and knowledge gaps through research. Additional efforts on the project pipeline (see Question 60) may be helpful to support supply of projects.

Question 90: Beyond the possible general measures referred to in section 1.6, would more specific actions related to banks' governance foster the integration, the measurement and mitigation of sustainability risks and impacts into banks' activities?

- Yes/**No**/Do not know.
- If yes, please specify which measures would be relevant. [BOX max. 2000 characters]

Additional comment:

The financial sector has put significant effort in recent years into ESG governance and adopting non-binding TCFD recommendations, as well as the measures that are in the pipeline (see Question 88). We therefore do not think it is necessary to introduce additional actions on governance. If further action is required, we would request coordination and consultation by the different regulators.

3.3 CREDIT RATING AGENCIES

Question 95: How would you assess the transparency of the integration of ESG factors into credit ratings by CRAs?

- Please express your view by using a scale of 1 (not transparent at all) to 5 (very transparent).
- If necessary, please explain the reasons for your answer. [BOX max. 2000 characters]

3 – Neutral

While credit rating agencies have made significant efforts in the past years to increase the transparency of how they are integrating ESG factors in credit ratings and have also increased the frequency and depth of their ESG research, further transparency on methodologies could help comparability and mapping of different ESG ratings.

Question 96: How would you assess the effectiveness of the integration of ESG factors into credit ratings by CRAs?

- Please express your view by using a scale of 1 (very ineffective) to 5 (very effective).
- Ifnecessary, please explain the reasons for your answer. [BOX max. 2000 characters]

3 - Neutral

While further transparency would be helpful in making the assessment, the effectiveness of the integration of ESG factors into credit ratings has improved with an increasing weight of ESG risks included into the analysis. However, the integration of ESG factors into credit ratings by CRAs can still be ineffective, for example where ESG factors are not adequately reflected. Generally, where an ESG factor is materially relevant it should be considered.

The signal of credit differentiation due to ESG factors could improve but CRAs are constrained by their 16-point scale. The area where CRA most underestimated ESG factors in credit ratings in the past was transition risk. On the other hand, physical risk has not been such a relevant factor due to its generally long-term time horizon.

Question 97: Beyond the guidelines, in your opinion, should the EU take further actions in this area?

- Yes/No/**Do not know**.
- If yes, please specify what kind of action you consider would address the identified problems. In particular should the EU consider regulatory intervention? [BOX max. 2000 characters]

Additional comment:

We note that ESMA has analysed the issue of sustainability considerations in the credit rating market in 2019 and concluded that (1) CRAs are already considering ESG factors in their ratings and (2) it would not be advisable to amend the CRA Regulation to more explicitly mandate the consideration of sustainability characteristics in credit assessments. We also note that the European Commission intends to report on the progress regarding disclosure of ESG considerations by CRAs in 2021. The report could inform consideration of future EU action as needed.

As we have noted in our answers to questions 95 and 96, further clarity and transparency on how CRAs are integrating ESG factors into their methodologies would be beneficial This would be particularly important for specialised ESG rating agencies which, in some cases, use widely varying methodologies, for example on definitions, weighting of ESG criteria, or assessment. Measures to promote comparison and mapping of different ESG ratings such as a "master scale" could be helpful.

3.4 NATURAL CAPITAL ACCOUNTING OR "ENVIRONMENTAL FOOTPRINT"

Question 98: Are there any specific existing initiatives (e.g. private, public or other) you suggest the Commission should consider when supporting more businesses and other stakeholders in implementing standardised natural capital accounting/environmental footprinting practices within the EU and internationally?

- **Yes**/No/Do not know.
- If yes, please list a maximum of three relevant initiatives. [BOX max. 2000 characters].

We see moves towards "best practices" and consider the SBTi and TCFD as some of the most relevant. With regard to natural capital accounting/environmental foot-printing practices there are some international public initiatives such as the impact tools from UNEP FI within the PRB framework, or on the private side True Price[13] and the Natural Capital Coalition[14], but the usability need to be assessed. WWF has likewise done good work on natural capital accounting.

While we support the Commission looking at these, the current scope of the EU sustainable finance regulatory effort should not expand to this topic yet as methodologies and tools need to be further developed.

3.5 IMPROVING RESILIENCE TO ADVERSE CLIMATE AND ENVIRONMENTAL IMPACTS

CLIMATE-RELATED LOSS AND PHYSICAL RISK DATA

Question 99: In your opinion, should the European Commission take action to enhance the availability, usability and comparability of climate-related loss and physical risk data across the EU?

- **Yes**/No/Do not know.
- If yes, please select all that apply:
    - Loss data, please explain why [BOX max. 2000 characters]
    - Physical risk data, please explain why [BOX max. 2000 characters]

Yes, such action would help ensure cross-comparability and benchmarking. Climate data should be centralised and made available for free to everyone, perhaps subsidised by the EU and UN. We note the IPCC has a data distribution centre (https://www.ipcc-data.org/) and Global Credit Data may also be worth approaching on this initiative. There is no benefit in everyone trying to develop their own climate models and the more we can make data available, the quicker it will get incorporated into risk models.

The EU should mandate the centralisation of as much data as possible. Understanding physical impacts and 'loss' will ultimately improvemodelling, hence companies reporting on it and then centralising the data will be beneficial. Nonetheless it is important to consider how this is set up for instance:

[13] https://trueprice.org
[14] https://naturalcapitalcoalition.org

- Consideration of non-European companies' data
- Achieving an international database potentially linked to the work of the NGFS
- Providing clarity on the breakdown behind the indicators (loss and physical data)
- How such a repository would be linked to other databases to avoid duplication
- Who would be required to provide the data (institutions or corporates)
- What is the envisaged timescale for establishing such a database

Loss data

It is unlikely that climate-related loss data could be used at present to build risk models in the near future. Long observation periods are often required. Yet, a database of historical losses due to physical hazards could constitute a basis to try to extrapolate future losses using climate physical scenarios.

Given the difficulty for banks to get and gather the ne E&S information needed to ensure a proper E&S risk analysis on their clients (and noting the fact that they might have the same clients sometimes), creating a common EU repository of extra-financial information on corporates (along with other information like assets location) to which banks could have access would be very useful.

Physical risk data

Usable and comparable climate scenarios along with risky area indicators (flooding areas, clay shrinking and swelling etc.) is necessary to better evaluate physical climate risk and perform objective risk assessments. Here again, they would help in projecting future losses for various scenarios. The homogeneity of such data over a large geographical area would foster the development of comprehensive qualitative and quantitative approach to measure physical risk.

FINANCIAL MANAGEMENT OF PHYSICAL RISK

Question 100: Is there a role for the EU to promote more equal access to climate-related financial risk management mechanisms for businesses and citizens across the EU?

- **Yes**/No/Do not know.
- If yes, please indicate the degree to which you believe the following actions could be helpful, using a scale of 1 (not helpful at all) to 5 (very helpful) and substantiate your reasoning:
  - Financial support to the development of more accurate climate physical risk models. [BOX max. 2000 characters]
  - Raise awareness about climate physical risk. [BOX max. 2000 characters].
  - Promote ex-ante "build back better" requirements to improve future resilience of the affected regions and or/sectors after a natural catastrophe. [BOX max. 2000 characters].
  - Facilitate public-private partnerships to expand affordable and comprehensive insurance coverage. [BOX max. 2000 characters].
  - Reform EU post-disaster financial support. [BOX max. 2000 characters].
  - Support the development of alternative financial products (e.g. catastrophe bonds) offering protection/hedging against financial losses stemming from climate- or environment-related events. [BOX max. 2000 characters]
  - Advise Member States on their national natural disaster insurance and post disaster

compensation and reconstruction frameworks. [BOX max. 2000 characters].

- Regulate by setting minimum performance features for national climate-related disaster financial management schemes. [BOX max. 2000 characters].
- Create a European climate-related disaster risk transfer mechanism. [BOX max. 2000 characters].
- Other, please specify. [BOX max. 2000 characters].

- **Financial support to the development of more accurate climate physical risk models:** Helpful - 4.
  We consider high resolution climate physical risk models will be necessary to make objective risk assessments since most transactions are made at client level (corporate or individual). The collection of asset locations of economic agents and the availability of this information for financial institutions is clearly of high importance to make use of such climate physical models.

- **Support the development of alternative financial products (e.g. catastrophe bonds) offering protection/hedging against financial losses stemming from climate- or environment-related events:** Helpful – 4.

  Any such action would be welcomed to develop the market.

Question 102: In your view, should investors and / or credit institutions, when they provide financing, be required to carry out an assessment of the potential long-term environmental and climate risks on the project, economic activity, or other assets?

- Yes / **No /** Do not know.
- If yes, what action should the EU take? Please list a maximum of three actions. [BOX max. 2000 characters]

No, we do not see the need for any new regulatory obligations now, but further standardisation and soft guidance in specific areas may be useful. To an extent this is considered in the EBA Guidelines on Loan Origination and Monitoring and will be expanded on in the ECB guide to climate and environmental risks.

Nonetheless, assessment of ESG risk could be complemented by information that concerns the financed or invested activities' short, medium and long-term impacts on climate as well as the activity's vulnerability to climate transition and physical risks. Climate change risk can be approached from a range of perspectives, including compliance with green and/or potential future brown taxonomy; whether the activity contributes to climate mitigation and/or adaptation; and whether there is any risk of contributing to locked-in technologies or a risk towards stranded assets. Considering the forthcoming scope of the Taxonomy, the assessment could also include assessing impacts on and vulnerabilities towards aspects like biodiversity, water resources and a circular economy. We would also support the development and standardization of scenario approaches, and guidance on decision-making horizons for different risk types in different geographies, which will no doubt be linked to the work of the NGFS.

When considering what additional guidance might be needed it is also important to make some distinction between project/asset financing and general lending. Specific project or asset level lending forms a smaller part of the overall loan financing, but with a clear target in terms of the project/asset being financed. A larger share of lending is so-called general-purpose lending, where the financed target is not specified. For such lending, further guidance on how to apply ESG including climate related criteria would be welcome.