Warsaw, 15 July 2020

Supplement to the UKNF response to the EC consultation on the Renewed Sustainable Finance Strategy

Below we provide an elaboration on some of our answers given through the questionnaire.

The below comments refer to questions: 6, 10, 11, 13, 16, 32, 40, 43, 44, 47, 50, 53, 57, 58, 59, 83, 86, 87, 90, 91, 92, 94 and 97.

Question 6

<u>Challenges and opportunities:</u>

1. The greatest challenge and opportunity is the post-crisis green recovery. Rebuilding economy after the COVID-19 crisis needs to be addressed in particular towards SMEs, as they were usually hit hardest by the crisis. Greening measures have to take this seriously into consideration.
   Localization-targeted action is crucial to effectively include SMEs in the green transition and that this is a huge issue for every MS. Localization is not protectionism. EC should consider taking steps towards building European recovery and transition strategy along with encouraging mirroring national strategies, thus accounting for smaller businesses and local conditions.
   Besides, supporting local businesses is very much in line with the concept of closed-circuit economy and thus – of a sustainable economy. Localization does not equal protectionism and cannot in any circumstances be interpreted that way.
   It is worth mentioning that investment capabilities in costly green instruments may be limited after the current pandemic crisis;

2. More incentives appear crucial for both sides i.e. for investors and credit institutions on one side and for issuers on the other, in order to allow for carrying on with the green transformation. A proper set of incentives is a challenge but also an opportunity for creating a solid bridge between investors and issuers. The incentives should reduce the investment gap and support sustainalibilty at the same time. The incentives for investors shall be aimed at reducing the level of investors' concerns/reluctance to invest in "green" (including measures to reduce greenwashing). They could e.g. relate to anti-greenwashing characteristics or provide for additional guarantees to reduce the level of risk assiciated with many new green or ESG projects as compared to "standard as-it-was-projects".

Challenges:

1. Prior to deciding on any measures regarding ESG risks/sustainability (legally binding or soft ones) a political agreement regarding the way-forward for particular sustainability-related actions would be indispensable. Such an agreement would be crucial for designing measures incorporating specific “E”-, “S”- and “G”-related regulations, standards, metrics etc. and then for their coherent understanding and implementation. In general, we perceive actions in this area as a cascade of actions which start at a the highest international level and then materialise in the most sector specific regulations. A good example follows from the case of the Paris Agreement, EU policy and measures which so far have followed (definitions of carbon footprint, total carbon emissions etc. contained in RTS disclosures draft). Moreover, international efforts are crucial in particular in the case of climate and environmental action as firstly, only by international action we are able to address climate and environmental challenges which know no borders, and secondly, by placing more regulatory burden only on some of the economies we create a competitive disadvantage for the companies operating in such economies vs the companies operating outside. Therefore, some additional action might be needed should the political agreement referref to above fail – see our answer to Q77as well;

2. Effective oversight of taxonomy/taxonomies application, in particular given that our aim is to effectively prevent greenwashing. This is a significant challenge as it is obvious that the use of taxonomy should be accompanied by an appropriate supervision mechanism. Supervision should be consistent, so that is does not lead to diverging judgements. However, this would be hard since it seems that multiple institutions might be involved in the supervision of using the same taxonomy (EU vs MS). There has to be a mechanism intended for convergence in this area;

3. Appropriate risk assessment of green activities assuring that all risks were taken into account as well as quantification of such risks. Firstly, data is limited which does not allow for applying standard statistical tools in the risk assessment process. Secondly, investments in sustainable projects/activities may cause additional risks which, due to data scarcity, we are not able to consider at the moment. Thirdly, data and information regarding the impact of some environmental factors should be based on solid scientific basis which is not currently avialable to an acceptable extent.

Opportunities:

As regards opportunities, in this case for the EU, we see a strong EU leadership role in developing methodologies for the implementation of a forward-looking approach by the market. This may come in the form of ready-to-use scenarios and a handbook on how to use them and profit from this usage. This is especially important for smaller market players as larger ones would often have the capacity to develop a framework aimed at addressing ESG risk (although at some point this should be obviously also harmonised and coordinated). We then see the EU’s role as an “ESG hub” – not only in terms of data and information provision but also in terms of practical guidance. Obviously, this would need to occur with special regard to existing national conditions in each MS, in particular the level of development of green markets and energy mix.

Therefore localization-targeted action is crucial as we want to effectively include SMEs in the green transition which is a huge issue for every MS.

Question 10

We believe that institutional investors and credit institutions should not be required to estimate and disclose which temperature scenario their portfolios are financing with 2°C, 3°C, 4°C as reference measures. We oppose such level of detail in formulating the achievement, not the estimation and disclosure as such. It seems impossible to verify such measures of achievement (2°C, 3°C, 4°C) in an objective manner.

Question 11

We would like to underline that biodiversity is included in the taxonomy only as a concept, but to be implemented in practice, it still requires more precise criteria to distinguish what should be considered as biodiversity.

Question 13

The most important critical issue is enhancing data availability, coherence and comparability. This is to be at least partially addressed by the NFRD revision to which the UKNF has contributed via separate consultation. We expressed our strong support for a voluntary and simplified disclosure standard for SMEs as we think that this is one of the ways to make sure that the proportionality principle is duly applied. Another principle which we indicated in our response is the subsidiarity principle, which is meant to allow for EU action only when no better action can be taken on a national level. This is to be reiterated in this context, and with reference to our answers to Q6 and Q12 above, that convergent action on the EU and national levels is needed and this does not contradict the idea that MSs should be provided with a kind of "a national path" in order to adjust EU-wide solutions to local conditions. This is particularly important for achieving just transition and for green recovery from the COVID-19 crisis as the pandemia might have resulted in even more divergence. Rebuilding economy after the COVID-19 crisis needs to be addressed in particular towards SMEs, as they were usually hit hardest by the crisis.

As regards the framing for the actions in question, we would prefer the form of recommendations and "good practices", rather than legally binding regulations.

In particular, we see a strong EU leadership role in developing methodologies for the implementation of a forward-looking approach by the market. This may come in the form of ready-to-use scenarios and a handbook on how to use them and profit from this usage. This is especially important for smaller market players, as larger ones would often have capacity to address ESG risk (although this should be obviously also harmonised and coordinated). We then see the EU's role as an "ESG hub" – not only in terms of data and information provision but also in terms of practical guidance. Obviously, this would need to occur with special regard to existing national conditions in each MS, in particular the level of development of green markets and energy mix. Therefore – also in this context – localization-targeted action and supranational cooperation is crucial (see as well the supplement to our answer – Q6).

Lastly, we could benefit from the crowdfunding framework which is being developed at the moment. Crowdfunding could be used as a means of raising capital for sustainability-related investments from smaller investors, which could be one way to solve the problem of large sums paid „at the entrance" as well (which we mention in our answer to Q35.1). To that end it seems that better financial literacy and more knowledge on capital markets on the side of investors would be of key importance.

Question 16

We do not support the idea of reintroducing recycling and impairment for equity instruments measured at FVOCI. The reintroduction of recycling for equity instruments measured at FVOCI may lead to the hazard of maintaining loss-making investments, which in turn requires burdensome implementation of an impairment model which would result in an asymmetric treatment of gains and losses. In our view, the prospect of such cascading difficulties is an additional argument against the reintroduction of recycling. We would also like to point out that the default FVPL measurement requirement for equity instruments provides an incentive to dispose of loss-making investments and leads to symmetric treatment of the changes in value of the investment.

Question 32

This should be considered particularly carefully as some standards have already been developed through market practice. It is especially important for market participants to be able to continue to rely on the existing practice as any new expectations could cause unforseen expenditure and costs. Any EU action in this area should be subjected to a thorough cost-benefit analysis and be exceptionally well justified. For now we do not see any strong justification.

Question 40

Such a rule probably would be very effective, but we see the problem of measuring the achievement of non-financial goals which would then have to effect in payment of the linked part of remuneration. Moreover, we would not support establishing a firm, mandatory linkage of a share or a fraction of remuneration with sustainability goals or performance of institutions, because we think this would be too stringent as a measure and probably would interfere too strongly with the freedom of economic activity as such. Nonetheless, we could think of some kind of qualitative linkage of institution's sustainability performance with directors' variable remuneration – but in no case this should be incorporated as a specific part or share or fraction of such remuneration.

Questions 43 and 44

We advise that great cautiousness should be applied in this respect. The members of management body of a company hold responsibility for e.g. investment policy, whereas shareholders do not.

Question 47

However, we see a significant risk of overburdening the market with too much regulation, which might result in jeopardizing competitiveness.

Question 50

We understand this question literally in a way that those offered sustainable products are indeed at a comparable cost and in particular they meet the suitability or appropriateness test. However we see a significant challenge in the assessment whether the cost is indeed comparable.

Otherwise, we would be against an obligation to offer sustainable investment products as one of the default options, where suitability and appropriateness criteria are not met. At the end it is always a distributor's responsibility to offer a product which meets both the needs and demands of the customer, which means that suitability and appropriateness must prevail, notwithstanding sustainability preferences.

Giving as an example the insurance regulation in this respect, suitability and appropriateness criteria are regulated in Articles 20 and 30 of IDD. If an insurance distributor proposes a product which is not aligned with sustainability needs of a client, such distributor may be subjected to responsibility, including sanctions. Sustainability has to be then considered as part of the assessment of suitability/appropriateness. It has to be considered that there are many aspects which may interfere with the final advice/offer by an insurance distributor, especially when IBIPs are taken into account – like recommended holding period, level of risk accepted, financial situation of a client. For example, a product with less liquid assets invested in long term sustainability investments could be not appropriate/suitable for a client who accepts only short-term investment horizon. All those aspects have to be considered and we cannot assume that sustainability will always prevail. We also see the risk of inappropriate incentives for distributors which may in the end of the day result in misselling practices.

Question 53

In terms of the characteristics of instruments, it may seem that bonds could have the best ability for precise capital allocation as the money is borrowed to finance particular investment. However, the greatest importance in this context should be always attached to investment's control mechanisms and transparency.

Question 57

We are not sure about how to understand "digital sustainable finance" in this consultation.

In our opinion, the example of the development of digitization in Kenya, provided by the EC, is not the best one to be brought up (since the money from retail bonds has been allocated, in this case, to infrastructure development, the question arises what the budget revenue from taxes is intended for).

In addition, in our opinion, revenues from retail bonds can be allocated to development, provided that in the era of low interest rates these bonds will bring real revenues.

Question 58

The same concerns remain as with regard to Q57.

In our opinion, in general terms, supporting digital finance development primarily serves to eliminate or at least reduce cash flow, which means that the “shadow” economy is limited and control over the flow of capital is increased. We believe that support for the development of digital finance will primarily have a fiscal goal (acquiring additional funds to finance specific goals relevant to the state and its institutions). In this context, we anticipate difficulties in successfully implementing tasks related to sustainable development. Justifying the promotion and support for the development of digital finance by the objective of "financing the transformation towards a sustainable economy" seems to be virtual. This is demonstrated by e.g. the type of entities who would become addressees of such a policy – namely consumers and retail investors.

In this context, we anticipate difficulties in the effective implementation of sustainability tasks.

However, if digitalisation in the financial sector is understood as the development of digital platforms aimed at promoting statistical and economic data taking into account ESG factors, including, respectively, a level of detailed, clear definitions available to public, private and institutional investors, as well as the inclusion in the revised NFRD a framework for providing common and reliable information, we would not object such an understanding of the development of the digitisation of the financial sector.

Question 59

Explanation as in our answer to Q58.

Question 83

We are in favor of focusing our efforts and resources (which are not unlimited) on the green part of the scale in order to make it precise. The current stage of the taxonomy development does not ensure that its unambiguous application is possible. Moreover, the whole spectrum of classification would be, in our opinion, very demanding and therefore the experience deriving from the application (and supervision) of the “green” taxonomy would be very much needed.

Question 86

In our opinion it is premature to decide on changes to the current macro-policy toolbox, especially regarding Pillar 1 regulations.

From the perspective of insurance market, current work on Solvency II 2020 Review involves a number of macro-prudential tools of different categories and we believe they should be given time to work before a decision to introduce other measures is made.

For the baking sector, EBA is mandated to produce targeted analysis on the basis of Article 98(8) of CRDV and Article 501c of CRR. We do not see why we should decide on any further changes or actions before those mandates are exercised.

See our answers to questions from Q87 to Q90 as well.

Question 87

We believe that the EU should take further actions to mobilize insurance companies or pension providers to manage climate and environmental risks, but not to finance the transition. We find it prudential to e.g. manage such risks via risk-sensitive pricing and underwriting.

There are many sometimes interconnected risks involved in buying SuFi-labeled products/investments and these products can be so costly that mobilizing insurance or pension providers to buy them may be contrary to the interests of clients of these institutions and the social/economic role of these institutions.

For those reasons we would not support at the moment any actions beyond prudential regulation. Moreover, we highlight that Pillar 1 regulations for the insurance market are under revision at the moment. Current works on Solvency II 2020 Review stipulate a number of macroprudential tools of different categories and we believe they should be given time to work before a decision to introduce other measures (beyond prudential included) is made.

Question 90

At the moment EBA is preparing the report on ESG risks inclusion in SREP (Article 98(8) CRDV mandate). We take part in the work in this respect and we expect the report to be very comprehensive and extensive, in particular – regarding the content of this question – we expect it to cover recommendations for banks (and investment firms) on how to include ESG risks in their governance framework (and their strategies). We support starting EC's future work regarding ESG risk frameworks in banks from this report.

Question 91

We think that the recently proposed direction of changes to Solvency Directive, IDD, MiFID, UCITS Directive and AIFMD is for this moment sufficient. Now, the discussion should be focused on the specific wording of the legislative amendments. The UKNF has contributed to this discussion via dedicated EC's consultation.

Question 92

In general, due to specific role of IORPs, we are against burdening them with obligations regarding pursuing sustainability-related investments. More explanation in this regard has been provided in our answer to Q94.

Moreover, we underline that, in our opinion, streamlining of such investments would not be possible due to the existing relation between the actual profit of a pension fund and the fees charged by IORP. The profit of the fund/entity providing retirement services consists of fees charged on an ongoing basis namely, the percentage of the premium and the management fee. These both forms of financing the business of such entities (= their remuneration) are not related to the actual profit resulting from managing/investing of entrusted funds.

What could be then possible options to streamline sustainable investing? You could delete the percentage of the premium and replace it with the percentage of the profit. However, in our opinion it is unlikely. Considering that the greener and balanced the investment would be, the higher the percentage of the return on investment was (in order to incentivize the managing firm) – the beneficiary of the retirement benefits would obtain less of those benefits. We think that the beneficiary of a retirement benefit in the context of investing through an entity providing retirement services has two main goals: to reach a certain age and to receive as much as possible from the capital contributed and the profit generated. Indirectly burdening him with responsibility for sustainable transformation seems inappropriate.

Question 94

The mechanism of integration of ESG factors into the investment strategies of IORPs should be exclusively voluntary, i.e. just the way it is at the moment, and further pressure should not be introduced. Moreover, we strongly support that every IOPR should be allowed to freely define a set of factors included in its investment strategy.

We would support the creation of tools intended for encouraging rather than mandating IORPs to take into account ESG factors in their long-term investment decisions.

One solution which could be considered are Defined Contribution IORPs with a defined target date (target date fund with ESG long-term preferences). However, in general, for many IORPs it could be challenging to handle variable ESG preferences and provide some level of guaranteed proceeds upon retirement at the same time (to limit losses close to retirement due date), considering the membership's characteristics and the goal of saving for retirement (liquidity issues, valuation and real capital protection upon retirement may be very challenging).

Question 97

In our opinion ESMA's guidelines should be sufficient for this moment, in particular for the purpose to increase transparency on how CRAs consider ESG factors in their credit ratings.

Credit ratings should primarily focus on assessing the creditworthiness of exposures. Under current regulations, credit rating agencies must consider all relevant factors in their methods of assessing creditworthiness. Therefore, no legislative changes are needed in this respect. Thus, ESG rating features could only be included in credit ratings if they are relevant to credit risk.