

## ISDA's detailed response to the European Commission Consultation on the Renewed Sustainable Finance strategy

15 July 2020

ISDA is providing responses either in standalone form and/or in coordination with AFME to Questions 3, 7, 15, 18, 29, 30, 33, 34 36, 39, 52, 53 and 88, which are of relevance from a derivatives perspective.

In relation to prudential aspects of the consultation we are endorsing AFME's responses to Questions 84, 85, 88, 89, while refraining from commenting on the possible creation of a 'brown taxonomy'.

The answers provided to all other questions set out in this response are endorsing AFME's respective positions.

ISDA's responses are highlighted in blue.

### 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.

#### Endorsing AFME's response

#### Additional comment [question does not provide an answer box]

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 through 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 and enabling the real economy sector to transform its business models. Financial market policy should not be seen as a substitute for other policy measures relating to environment, climate, or social issues.

**Question 3:** When looking for investment opportunities, would you like to be systematically offered sustainable investment products as a default option by your financial adviser, provided the product suits your other needs?

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

ISDA would like to reiterate the following points that were made in its joint [response](#) with AFME to the draft Delegated Directive on product governance and the draft Delegated Regulation on suitability and firms' organisational requirements under MiFID II:

Retail investors generally have legitimate investment needs which may be in addition to their ESG considerations (e.g. portfolio diversification and/or solutions to hedge risks). It is therefore essential that manufacturers can create products that meet such investors' needs, even when the product is unrelated to ESG. In order to avoid limiting the availability of such products to investors who have expressed ESG preferences, it should be clarified that the negative target market does not apply to ESG considerations. This would be in line with the Commission's approach to suitability, which tends to clarify that ESG considerations are preferences that complement an investor's other expressed investment objectives.

In practice, an investment service provider should identify the relevant investment universe according to the usual suitability test criteria. On the basis of the investment range selected, the investment service provider checks whether proposing ESG products is relevant, taking into account the needs expressed by the investor. By way of example, for a retail investor that seeks to invest only in long term solutions with a preferred tax treatment (e.g. retirement saving plans), the expression of an ESG preference by such investor should not lead to an unfavourable arbitrage between the two sets of specifications. The investor should be confident that the ESG preference will not conflict with his/her previously expressed preferences which may be unrelated to ESG.

**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.

Endorsing AFME's response

Additional comment [question does not provide an answer box]: We recommend a phased disclosure approach, whereby corporates start first by disclosing more granular and globally consistent information about their path to Paris Agreement alignment. This data will then help financial institutions to assess the extent to which they might be able to set/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 or transitional path 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. Principals 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). **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). **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]

#### **Endorsing AFME's response**

Additional comment [question does not provide an answer box]: 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].

#### **Endorsing AFME's response**

#### **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. Navigating the sustainable finance framework with partly overlapping initiatives and requirements. 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 requirements.
2. Challenges exist with respect to the 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. A number of challenges relate to 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<sup>1</sup>:
    - a) Multiple and diverse sustainability frameworks and standards;
    - b) Lack of common definitions of sustainable activities; and
    - c) Greenwashing and other investor protection challenges.
  - 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

<sup>1</sup> <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD652.pdf>

as much as possible, given competitive implications for the sector and broader economy when dealing with brown/transitioning assets (as noted in our response to Q5);

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 for European investment firms, who may be concerned 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, which risks creating investment uncertainty in relation to those sectors. ISDA is of the view that such sequencing would risk distorting the market by enabling some technologies to access sustainability funding before others. AFME and ISDA would support 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).

**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].

The response to the Covid-19 pandemic has put the European Green Deal at the heart of the EU's recovery plan. Sustainability-linked products –whose liquidity, price transparency and attractiveness to investors can be further enhanced through the use of derivative instruments – can attract much-needed investment for research and the low-carbon transition. Such investments have long-term objectives and require a long-term orientation. To this end, derivatives contracts can play a very important role in achieving the three main goals of the Sustainable Finance Action Plan (SF Action Plan). This is because derivatives:

- i) can enable the EU to raise and channel the necessary capital towards sustainable investments;
- ii) help firms hedge risks related to ESG factors;
- iii) facilitate transparency, price discovery and market efficiency; and
- iv) contribute to long-termism.

As highlighted in our response to Question 29, ISDA is particularly concerned about potential restrictions being put on professional and/or retail investors in terms of using derivatives as part of their portfolios in the context of the draft Ecolabel report. Derivatives are an efficient low-cost tool for investment firms to manage their portfolio risks and they enable capital to be freed up for investments by appropriately adapting the risk profile for both issuers and investors. Being an efficient risk management instrument, derivatives can be channeled towards environmentally friendly investments. They allow two parties with different tolerances and expectations about climate risks to transact for their mutual benefit and, in so doing, finance climate adaptation.

It is widely acknowledged that the use of derivatives can bring benefits, such as increased liquidity and supply of credit to the market. At present, ESG investments generally represent a limited fraction of the bond or stock markets. With the upcoming EU Taxonomy Regulation, it is anticipated that this selection could become even more restrictive. As a consequence, professional and retail investors are expected to opt for portfolio diversification solutions that will allow them to hedge risks and/or limit trading costs through the use of derivatives. The long-term sustainability of their involvement in ESG markets is highly dependent on their capacity to hedge their positions via the use of derivatives. Therefore, investment firms are more likely to make longer-term investments if they are able to efficiently hedge the risks of such investments.

### **Endorsing AFME's response**

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<sup>2</sup> & IIF's work<sup>3</sup> 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

<sup>2</sup> <https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/Sustainable-Finance-High-Level-Definitions-May-2020-110520v4.pdf>

<sup>3</sup> <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>



- 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](#)<sup>4</sup>.

**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 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]

#### **Endorsing AFME's response**

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.

<sup>4</sup> [https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20ISDA%20NFRD%20revision%20consultation%20response\\_Final\\_11062020.pdf](https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20ISDA%20NFRD%20revision%20consultation%20response_Final_11062020.pdf)

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, 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]

#### **Endorsing AFME's response**

##### **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**

**Endorsing AFME's response**

**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,<sup>2</sup> 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]

**Endorsing AFME's response**

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 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]

**Endorsing AFME's response**

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 ambitions.

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]

**Endorsing AFME's response**

Further action should focus on:

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

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

International and institutional coordination is needed for the successful and effective transition to sustainability. 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, and 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]

#### Endorsing AFME's response

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).

### 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]

#### **Endorsing AFME's response**

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 from the IASB board member usefully highlights how the IFRS can be applied (<https://www.ifrs.org/news-and-events/2019/11/nick-anderson-ifrs-standards-and-climate-related-disclosures/>).

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 and loans, 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 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 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]

#### Endorsing AFME's response

#### 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/rating for any given company.

Variety in general is positive, as firms can choose the approach that makes most sense 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 amounts and kinds 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. We also welcome that the Commission has officially mandated 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.

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

##### *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, 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]

##### **Endorsing AFME's response**

##### **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 will 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 29:** Should the EU establish a label for investment funds (e.g. ESG funds or green funds aimed at professional investors)?

- Yes/No/**Do not know**.
  - If necessary, please explain your answer [BOX, 2000 characters]
- If yes, regarding green funds aimed at professional investors, should this be in the context of the EU Ecolabel?
  - **Yes**/No/Do not know
  - If necessary, please explain your answer [BOX, 2000 characters]

ISDA is of the view that if such a label were to be developed, allowing for more transparency and comparability in the market, it should be considered in the context of the ongoing work by the Joint Research Centre (JRC) to develop an EU Ecolabel for financial products with a view to ensuring policy consistency and to avoiding inefficiencies and greater costs for the industry.

As stated in the recent ISDA response to the EU Ecolabel [consultation](#), the Ecolabel criteria and portfolio thresholds should allow sufficient flexibility in order to promote and support a wide future uptake of the Ecolabel. Otherwise, the end goal might be jeopardized if only a handful of retail and/or institutional funds are considered eligible to obtain the Ecolabel. The various thresholds should be calibrated progressively and in coordination with the other EU sustainability initiatives with a view to avoiding potential duplications that could create unnecessary administrative burden for market participants.

ISDA believes that such a fund could be viewed positively by the market in terms of contributing to appropriate portfolio diversification solutions only to the extent it does not imply a compulsory approach (i.e. with all ESG funds obliged to comply with a predetermined list of specifications). In terms of industry demand, more broadly, it should be recalled that some products that are nominally dedicated to professional investors may indirectly end-up in a retail offering. This is notably the case when funds are structured in a master-feeder architecture. In those situations, it might be interesting for professional investors to benefit from ESG solutions that are compliant with the EU Ecolabel so as to build other investment solutions that rely on these labelled funds.

Overall, ISDA believes it should be left to the discretion of the asset managers to decide whether to opt-in to this new label or not as they often have bespoke or specific investment demands that lead to bespoke solutions. A very granular label for professional investors could risk causing a channelling of institutional capital to very niche activities/markets. Therefore, the criteria for developing such label should be based on broad principles of sustainability to allow maximum flexibility and responsibility for each asset manager.

Currently, the Joint Research Centre's (JRC) draft technical report on the development of an Ecolabel for retail financial products proposes a number of requirements for the use of derivatives by retail funds whereas it excludes synthetic replication in the context of passive management through the conclusion

of performance swaps by ESG funds. The latter would not allow the derivative provider to hedge its position and thus bring more liquidity to the ESG underlyings. Such a strategy is also considered less costly for the end investor because of the optimisation allowed by the use of derivatives.

In the context of the development of such labels, ISDA considers it is essential that professional and/or retail investors are not prevented or excessively restricted from using derivatives as the use of derivatives can bring benefits, such as increased liquidity and supply of credit to the market. At present, ESG investments generally represent a limited fraction of the bond or stock markets. With the upcoming EU Taxonomy Regulation, it is widely anticipated that this selection could become even more restrictive. As a consequence, professional and retail investors are expected to opt for portfolio diversification solutions that will allow them to hedge risks and/or limit trading costs through the use of derivatives.

**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]

#### **Endorsing AFME's response**

#### **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 instruments (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.

**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]

#### **Endorsing AFME's response**

#### **2 – Disagree**

As noted in Q30, 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.

**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]

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 LCB, 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). LCB 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 LCB 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]

**Endorsing AFME's response**

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.

**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**

**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]

**Endorsing AFME's response**

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.

**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]

#### **Endorsing AFME's response**

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]

### Endorsing AFME's response

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]

Derivatives are a core component of financial markets and have become more transparent and standardised since the 2007-08 financial crisis. Derivatives markets can play a significant role in the context of the European Green Deal and the transition towards a low-carbon economy. They facilitate capital raising via the hedging of risks related to sustainable investments. Moreover, they enhance the transparency and the price formation process of the underlying securities, and thus promote long-termism.

More specifically, derivatives are an efficient low-cost tool for investment firms to manage their portfolio risks and they enable capital to be freed up for investments that could be reoriented towards preventative and recovery efforts. Derivatives can be used to assist the ability to tap funding sources, by appropriately adapting the risk profile for both issuers and investors. They allow two parties with different tolerances and expectations about climate risks to transact for their mutual benefit and, in so doing, finance climate adaptation.

Therefore, investment firms are more likely to make longer-term investments if they are able to efficiently hedge the risks of such investments. In other words, the long-term sustainability of their involvement in ESG markets is highly dependent on their capacity to hedge their positions via the use of derivatives. The liquidity-provision function of 'market makers' plays a central role in that regard, as the long-term sustainability of their involvement is highly dependent on their capacity to hedge their global-netted positions on derivatives markets (in addition to their no-less sizable hedges on cash markets). However, current market practices often prompt market participants to focus on short-term performance rather than medium to long-term objectives.

It is crucial to distinguish short term from short duration. An investment or a financing operation with shorter duration or lower maturity (e.g. short-term trading, liquidity management, treasury, or trade credit) should not be confused with short-termism. Investing in shorter duration could be a sound long-term strategy for investors. Short-term market liquidity is a vital factor in allowing long-term investors to value their assets appropriately and invest. Derivatives are a tool that can support both long-term and shorter-term investment strategies, rather than an indicator of the type of strategy undertaken. Opting for most liquid positions to gain exposure to one market segment, even when there is no underlying risk to hedge, does not prove an intent to trade short-term. Derivatives may have to be rolled or renewed but the exposure may be maintained over a long-term period.

In light of the above, and as stated in our response to Q29, ISDA would like to caution against any potential restrictions put on the use of derivatives by market participants in the context of sustainable finance that could hamper market liquidity and the supply of credit to the market. At present, ESG investments generally represent a limited fraction of the bond or stock markets. With the upcoming EU Taxonomy Regulation, it is widely anticipated that this selection could become even more restrictive. As a consequence, professional and retail investors are expected to opt for portfolio diversification solutions that will allow them to hedge risks and/or limit trading costs through the use of derivatives.

## **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]

**Endorsing AFME's response**

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.**

**Endorsing AFME's response**

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.

**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]

## Endorsing AFME's response

### 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.

Moreover, the ESAs consultation in relation to draft RTS under the sustainability-related disclosures Regulation suggests that financial market participants should explain how the use of derivatives is compatible with the environmental or social characteristics being promoted, or with the sustainable investment objective pursued. Disclosures in relation to information about ESG practices are a fundamental element of sustainability. However, it is unclear how exactly the proposed requirements would be enforced without creating additional administrative burdens and costs for market participants. As ESMA acknowledged in the recent hearing on this matter, there is a need for more guidance, which would be added in level 2, or otherwise level 3 measures.

A further consideration could be for the EU to monitor the levels of ESG investments, e.g. on an annual basis. Better measurement of 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]

As mentioned in ISDA's response to Q29 above, it is important to note that any substantial capital-raising exercise cannot be performed without the ability to hedge risks and exposures. Derivatives are an efficient low-cost tool for investment firms to manage their portfolio risks and they enable capital to be freed up for investments that could be reoriented towards sustainable investment projects. Derivatives can be used to assist the ability to tap funding sources, by appropriately adapting the risk profile for both issuers and investors. They allow two parties with different tolerances and expectations about climate risks to transact for their mutual benefit and, in so doing, finance climate adaptation.

An ISDA-commissioned paper from the Centre for European Policy Studies (CEPS) on the role of derivatives in sustainable finance notes the following to that end:

*"Financial institutions such as banks use derivatives (such as CDS) to hedge their credit risk exposure to borrowers, and thus potentially increase the supply of credit to firms with sustainable and environmentally friendly investment projects. Empirical evidence suggests that the ability of lenders to hedge their credit exposures makes them more willing to extend credit. In particular, the use of CDS is associated with increased availability of credit (larger and longer-dated loans) and decreased borrowing*

*costs for ‘reference entities’. It allows such entities to use those additional funds to finance productive investment opportunities, thereby increasing aggregate investment and economic growth.*

*Derivatives can also act as an asset-management intervention tool. For example, a tool that allows firms to manage the ‘funding’ risk of species’ recovery and restoration (Mandel et al., 2010; Little et al., 2013). In the absence of such a source, recovery efforts from an environmental or climate catastrophe would require unbudgeted expenditure from government, public entities, or forgone income, and may potentially lead to prolonged, severe losses borne by those that rely on the natural asset. In the context of a more sustainable financial system, derivatives could also contribute to mitigating existing and future risks linked to biodiversity loss and health emergencies, such as the Covid-19 outbreak.*

*In that respect, derivatives will support public and private entities to free up capital that could be reoriented towards preventative and recovery efforts. For example, by buying a derivative whose value is based on the population viability of a species prior to becoming distressed, a government or municipality could transfer the risk of such an event and thus free up capital reserved for recovery efforts, should these be needed.”*

### 2.3 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]

#### **Endorsing AFME’s response**

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-à-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]

#### **Endorsing AFME's response**

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.

### 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]

### 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]

### Endorsing AFME's response

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]

#### **Endorsing AFME's response**

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

### **3. REDUCING AND MANAGING CLIMATE AND ENVIRONMENTAL RISKS**

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

#### **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]

### **Endorsing AFME's response**

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 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 these 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 so they have already been identified, and 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 risk will show its major impacts over a longer timeframe and its impact will include not only damages from climate related events, but also second order effects. Again, this could on 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 should 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]

#### **Endorsing AFME's response**

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. We also consider that bank disclosures should be made at parent level for both EU and international banks. This will also allow investors to have the appropriate information at the decision-making level.

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, for instance Green Bonds issuance for (re)financing of assets which exclude financing of coal mining and fossil fuels. Risk management functions are starting to evaluate climate risks via the more precise identification of clients which could have potential climate risks 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.

#### ***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]

### **Endorsing parts of AFME's response**

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:

**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

### **Market risk impact / Counterparty Credit Risk impact**

We are overall supportive of initiatives such as the ECB’s guidance on climate risk setting out expectations for firms’ to assess and evaluate climate risk in their market risk management framework. Specifically, on the trading book, the ECB calls to consider how climate and environmental risks could lead to potential shifts in supply and demand of financial products and subsequent impact on their value including at a minimum:

- risks arising from debt, equity and equity-related financial instruments in the regulatory trading book, as well as
- FX positions and commodities risk positions assigned to both the trading and banking book

The ECB also stress internal stress testing as important to “better understand and assess the relevance of climate-related risks for an institution’s trading and banking book. Institutions are expected to conduct a rigorous programme of stress testing. Such internal stress tests are expected to address climate-related and environmental risks alongside other risks”.

**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.

### **Endorsing AFME’s response**

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.

