Association for Financial Markets in Europe

Embedding Transition Finance into European Taxonomy framework

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The Association for Financial Markets in Europe (AFME) regards the EU Taxonomy Regulation (the "Taxonomy" or the "Regulation") as the flagship legislative framework that could play a crucial role in driving the economic shift to meet the goals of the Paris Agreement - not only at the EU but also at the international level through setting a scene for international collaboration and convergence on the development of globally consistent approaches to defining sustainable activities. We value the Taxonomy as a tool that provides an objective, science-based, approach to identifying economic activities that exhibit the degree of environmental performance aligned with achieving the Paris Agreement targets.

Whilst appreciating the value of the Taxonomy and consistent with our views expressed in the past[1], we stress that it is crucial to have a framework in place that would fully reflect the need and capacity for the economy to transition to a low carbon imperative. As noted in the recent study by the Global Financial Markets Association (GFMA) and Boston Consulting Group (BCG)[2] ("GFMA-BCG study"), the volume of financing focused on enabling climate change mitigation, that will be necessary to limit the global temperature rise to 1.5° Celsius, will have to grow to over $100–150 trillion cumulative (with Europe's investment needs comprising 17% of this amount) in the next three decades to decarbonize 10 sectors responsible for 75 percent of global emissions[3]. This largely implies that the investment will have to be allocated to the transition of the largest high-emitting sectors before the "pure green" finance can become truly mainstream.

We acknowledge and appreciate that the Taxonomy, as currently designed, already provides for some transition aligned elements, such as:

- The Regulation refers to "transitional activities" as making a substantial contribution within sectors where low carbon alternatives are not yet available (subject to meeting specific technical requirements)[4] and thus caters in some respect for the need to support the transition.
- The Regulation explicitly defines "enabling activities" as activities that can directly enable other activities to make a substantial contribution to one or more of the environmental objectives[5].
- The Taxonomy recognises certain eligible investment into research, development and innovation dedicated to the reduction, avoidance or removal of GHG emissions.

[1] AFME position on the Taxonomy Report by the EU Technical Expert Group on Sustainable Finance - https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20position%20on%20TEG's%20Report%20on%20Taxonomy%20-%20Final-1.pdf
[2] GFMA-BCG Report on Climate Finance Markets and the Real Economy: https://www.sifma.org/wp-content/uploads/2020/12/Climate-Finance-Markets-and-the-Real-Economy.pdf
[3] Representing an average investment of $3–5 trillion+ per year globally for decarbonization of 10 sectors that represent 75 percent of global emissions
[4] According to Article 10(2) of REGULATION (EU) 2020/852 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 (Taxonomy Regulation),"…an economic activity for which there is no technologically and economically feasible low-carbon alternative shall qualify as contributing substantially to climate change mitigation where it supports the transition to a climate-neutral economy consistent with a pathway to limit the temperature increase to 1,5 0C above pre-industrial levels, including by phasing out greenhouse gas emissions, in particular emissions from solid fossil fuels, and where that activity: a) has greenhouse gas emission levels that correspond to the best performance in the sector or industry; b) does not hamper the development and deployment of low-carbon alternatives; and c) does not lead to a lock-in of carbon-intensive assets, considering the economic lifetime of those assets."

[5] Article 16 of Taxonomy Regulation: "…provided that such economic activity: (a) does not lead to a lock-in of assets that undermine long-term environmental goals, considering the economic lifetime of those assets; and (b) has a substantial positive environmental impact, on the basis of life-cycle considerations."

- The Taxonomy recognises certain capital and operating expenditure related to assets or processes associated with economic activities that qualify as environmentally sustainable.

Furthermore, we thank the EU Platform on Sustainable Finance for organising a public outreach on the 24th and 26th of February 2021, sharing insights how the current Taxonomy can be used to facilitate transition noting that it can and should be used by companies in combination with other elements to demonstrate their transition pathways towards net-zero GHG targets[6].

Whilst all of the above components are important, we still believe that the current legal framework might significantly limit the potential for channeling capital flows to helping high emitting sectors to move towards Paris-aligned climate targets. One of the market challenges associated with taxonomies pinpointed by the GFMA-BCG study[7] relates to exclusion of transition activities, defined on the basis of the company transition potential, and resulting lower flow of capital for transition. The report presents a view that AFME fully echoes:

"Financing so far has focused mostly on the ends of the spectrum (i.e., financing low-carbon "green" economic activities and excluding high-carbon-intensity "brown" activities). ***A viewpoint that includes the transition potential of firms and assets of activities is often lacking****—and hence this remains a "static" viewpoint.* ***Instead of the "green" or "brown" classification of the primary sector in which a company operates, it is its commitment and ability to adapt its business model that should determine the classification of its economic activity.*** *This transition is critical to achieving Paris Agreement objectives. The lack of clear inclusion of transition activities leads to lower issuances and the curtailing of transition activity."*

Therefore, we think that the EU Taxonomy framework should maintain its dynamic spirit and could be complemented with an additional transition-oriented approach ("Transition Framework") to reflect the following features.

1. Entity-level application

The Transition Framework should be **applicable, in a simple way, not only to economic activities** but also **more broadly to entities,** for example, based on the level of emissions measured at the entity level[8]. The currently recommended approach to assess environmental profile of an entity based on the share of its turnover from environmentally sustainable activities in the total turnover is only workable for largely domestic entities with a few core activities.

The entity level approach would, for instance, expand the eligibility to operating capital for transition framework aligned enterprises that require operating capital rather than financing of specific green projects. Such an approach would significantly help mobilise the "general-purpose" sustainability linked finance via a wide range of financial instruments (loans, bonds, equity, derivatives, structured products, hybrids etc.).

2. Credible, science-based, Paris-aligned transition plans

Ability to facilitate client engagement and adoption of robust transition plans by companies should be at the heart of any taxonomy that recognizes transition activities. The Transition Framework must include both **activities and entities that are already low carbon** but also **take a forward-looking viewpoint**

[6] Such as presenting the decarbonization and climate change adaptation strategy; setting up climate governance; disclosing relevant metrics such as green revenues, carbon intensities and absolute emissions; disclosing of short, medium and long-term emissions reduction and capex-alignment targets; and others.
[7] Page 127 GFMA-BCG Report on Climate Finance Markets and the Real Economy: https://www.sifma.org/wp-content/uploads/2020/12/Climate-Finance-Markets-and-the-Real-Economy.pdf
[8] An example set of principles for a transition framework that can be applied at an entity level vs an activity level (page 5) can be found in the whitepaper published by Climate Bonds Initiative and Credit Suisse "Financing Credible Transitions" - https://www.climatebonds.net/transition-finance/fin-credible-transitions

to be inclusive of firms, their assets, and their activities that have the commitment and potential for transition within scientifically determined thresholds[9].

Transition plans should therefore embed science-based approaches to building decarbonization trajectories (such as, for example, those built based on internationally adopted PACTA methodologies or Science Based Targets (SBTi). Transition plans should be subject to independent verification by an accredited organization. In addition, the Transition Framework could include criteria or provide guidance helping assess companies' commitments and related feasibility to transition their economic activities, including guidance on the role of the impact of available innovative technologies on the assessment of specific economic activities or entities.

To this end, we also note that the overall trajectory path of the transition process is guided by Member States' paths to Paris Agreement goals. The more detailed these trajectory paths from today until 2050 are outlined, the more accurate the individual paths of all material stakeholders in the economy can be. As noted in our response to the Commission's consultation on the Renewed Sustainable Finance Strategy[10], the Commission, in cooperation with Member States, should facilitate the establishment of clear industrial transition pathways for a measured and gradual reduction in GHG emissions towards the 2050 goal, including policy signals on the appropriate pace of phasing out certain assets that are likely to be stranded in the future. These pathways are a necessary condition to enabling the measurement of transition alignment by the real economy and to stimulating the growth of transition aligned finance.

3. Harmonisation and comparability with international taxonomies

Financial transactions, including sustainable finance, are global in nature. Whilst we appreciate that it would not be possible to achieve a single, uniform global taxonomy considering the fact that regional specificities would need to be accounted for, we believe that **the development of regional taxonomies should follow a set of common, globally consistent principles and, as such, the evolution of the EU Taxonomy should take such international taxonomy developments into account.**

We see that several regional markets plan to or have already started working on their own taxonomies. We thus believe that European Commission, together with the European Platform on Sustainable Finance, have a critical role to play in promoting international harmonisation in this space through the work of the International Platform on Sustainable Finance related to developing of a common ground taxonomy. A GFMA-BCG study[11] outlines seven core principles and other recommendations for the development of regional taxonomies, which we hope can assist the Commission in its endeavour.

[9] We note that the Green Finance Industry Taskforce (GFIT), convened by the Monetary Authority of Singapore (MAS), has recently issued a proposed taxonomy for Singapore-based financial institutions to identify activities that can be considered green or transitioning towards green based on a phased three-step system:

- First: identify "end state", consistent with building blocks of EU taxonomy
- Second: adopt traffic light system
  - o Green: Activities/companies aligned with the objectives or in transition towards it
  - o Yellow: Activities/companies with quantifiable and time-bound pathways towards green/significant de-carbonization but not yet undertaking a transition consistent with these pathways
  - o Red: Activities companies inconsistent with the objectives (e.g. where viable alternatives already exist, or that fail to meet "do no significant harm" criterion)
- Third: Establish more granular criteria and timeline for transition for yellow activities.

(it is recognized that the treatment of transitioning sectors or businesses that enable transition will be a critical component of the classification system, but that it also needs to be balanced by not diluting the thresholds of the classification system)

[10] https://www.afme.eu/Portals/0/DispatchFeaturedImages/200715_Consultation%20Response%20renewed%20sustainable%20finance%20strategy_Final%20response%20and%20Key%20messages.pdf

[11] Pages 127-133 of GFMA-BCG Report on Climate Finance Markets and the Real Economy: https://www.sifma.org/wp-content/uploads/2020/12/Climate-Finance-Markets-and-the-Real-Economy.pdf

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About AFME

AFME (Association for Financial Markets in Europe) advocates for deep and integrated European capital markets which serve the needs of companies and investors, supporting economic growth and benefiting society. AFME is the voice of all Europe's wholesale financial markets, providing expertise across a broad range of regulatory and capital markets issues. AFME aims to act as a bridge between market participants and policy makers across Europe, drawing on its strong and long-standing relationships, its technical knowledge and fact-based work. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) through the GFMA (Global Financial Markets Association). For more information please visit the AFME website: www.afme.eu. Follow us on Twitter @AFME_EU