AFME's feedback on TEG's Taxonomy report

Feedback on the usability of the Taxonomy and Feedback on the 1st round of climate round mitigation activities

22 February 2019

A. USABILITY

1. ***Referring to the Activity Sheets (see 6.1 Example sheet: Energy Production (Geothermal) and in Part D: Full list of 1st round climate mitigation activities, screening criteria and questions) do you believe the Taxonomy will provide a clear indication of what economic activities should be considered environmentally sustainable?***

AFME welcomes the progress made by the Technical Expert Group on the taxonomy. Delivering the taxonomy is a vital first step before incorporating sustainability considerations in other parts of the financial regulations.

The proposed taxonomy provides a clear structure for the classification of the economic activities that should be considered environmentally sustainable. However, the current taxonomy requires important clarifications on the specific criteria, including of "the do no harm" criteria, so that the framework can be as easily usable as some of the existing standards. In addition, we consider that more guidance is required on how the complexity of a diversified client undertaking a range of economic activities would be assessed and implemented.

Whilst we understand the end goals and final aspirations of the taxonomy, the proposal does not allow sufficient flexibility for economic activities in transition, meaning activities in companies that are taking meaningful strides towards environmental sustainability, and tends to focus exclusively on investments that are already fully sustainable (e.g. the role for gas and nuclear in the interim). We believe that this approach would fail to build a tool that could help a wide range of economic activities to plan and achieve their transition strategy.

The taxonomy does not consider the practicalities of servicing a client investing in a company that will be subject to new technology or evolving business models. The taxonomy fails to take into consideration new technological or business model developments as it appears to be constrained at a particular point in time. Sectors and associated business models are evolving quite rapidly in response to numerous challenges, so that it may be unlikely that a stable and mature taxonomy could ever be achieved. Therefore, it is important that the taxonomy adds an element of ongoing flexibility so that new technologies and business models can be incorporated. It is important to include a mechanism in the taxonomy proposal which will facilitate regular updates of the taxonomy in response to the relevant changes in the evolution of industry sectors and new business models. This could be achieved by empowering the Platform on Sustainable Finance set out in Article 15 of the taxonomy regulation or a similar standing body comprised of EU authorities and market participants to regularly (e.g. every two months) update the taxonomy to keep it relevant and ensure the Taxonomy is up to date with market developments. In addition, a clear and open communication to the market of these updates are critical for the success and continued relevance of taxonomy.

Our members will need to perform a robust but pragmatic review process for keeping the customer tags and/or rating up to date as the frequency of customer review will incur costs. The taxonomy should evolve ensuring alignment to market demand of sustainable information, products and services, ensuring usability against both back book and future market demand.

2. ***Do you expect any practical challenges within your organisation to classify an economic activity according to the taxonomy?***

We consider that more guidance is needed with regards to the treatment of activities that evolving in or out the taxonomy framework.

We expect that the identification of economic activities that are environmentally sustainable by investors may vary widely according to the information available. Therefore, we would recommend the taxonomy to be suitability aligned with the work undertaken by the TEG on climate-related disclosures. Such consistency should also be ensured with other parts of existing and future financial regulations such as the amendments to Capital Requirements Regulation ("CRR") around incentives and ESG integration into the Supervisory Review and Evaluation Process ("SREP").

3. ***For financial market participants: will the proposed structure and format of the Taxonomy enable you to comply with the potential future disclosure obligations? If not, what changes would you propose?***

We consider that the proposed structure would have a positive market impact and facilitate potential future disclosure obligations. For instance, the taxonomy would facilitate alignments for definitions and metrics in the context of any potential future scenario analysis. However, we stress that potential future disclosure obligations are not yet known. For this reason, we strongly encourage that the development of a workable and flexible Taxonomy framework is achieved prior to any important review of existing financial regulations, including in relation to disclosures.

The current taxonomy work is based on the NACE classification system, which may not be use by all market participants. We therefore recommend the taxonomy to allow for some flexibility with other existing industry classification systems such as the Industry Classification Benchmark (ICB) or the General Industry Classification System (GICS).

4. ***Is the proposed taxonomy approach sufficiently clear and usable for investment purposes? If not, what changes would you propose?***

As stated in question 3, we support consistency between the various pieces of regulations in the context of the Action Plan. Such approach is necessary when financial market participants will build investment solutions that will take into considerations various sources of information and build reporting to facilitate the interaction with a client. We support a taxonomy that could be used across the entire capital chain from issuing green bonds, selling green bonds and for market participants' internal operations.

Additionally, whilst the taxonomy is intended to enable classification of economic activities, it does not say whether the geographical location of these activities is relevant for its application. AFME expects the taxonomy to apply to any economic activity regardless of its geographical location. If this was not the case, it will ignore environmentally sustainable finance opportunities, for example, in emerging markets.
Given the global scope of sustainability issues, it is important that the EU taxonomy is adaptable to economic activities and investments on a global basis, without creating an unlevel playing-field for EU entities operating in third-countries. The EU taxonomy would need to be calibrated in such way that it can be replicated by third-countries and in such way that it does not affect the competitivity of EU market participants globally, whilst keeping the EU market for sustainable investments and projects attractive to foreign investments. At the same time, we recommend EU institutions to promote actively the use of the EU taxonomy approach in third-

countries with non-EU policymakers at global fora so as to encourage convergence in global best-practice standards.

5. Would the use of the taxonomy require any additional resources (for example in human resources or information technology). If yes, please specify and if possible, give an indication of the expected costs.

AFME members consider that the implementation of the taxonomy and other regulations in the context of the Action Plan on Sustainable Finance will require additional resources. Such resources are required to implement a new framework alongside the value chain, to analyse the customers' impact, to integrate the framework into existing technology platforms. We anticipate the need for a significant IT/analytics capability requiring additional technical resource to scan across financial market participants entire lending book. This introduces a third dimension to the financial market participants' entire reporting system and will have a significant impact on their usual operational processes. Financial market participants assume that every single exposure, asset and liability, would need to be tagged with an element of the taxonomy and have this as a live feed linking to a capital measure and risk rating. Investigation into whether this burden could be eased by alignment to an existing industry classification standard would be welcomed.
Therefore, a balance is needed between the details required and the additional burden on companies and financial market participants. We recommend additional guidance and guidelines on how financial market participants should implement the taxonomy as well as on how to link general lending to a specific economic activity as defined by the taxonomy.

6. Please provide any additional comments on the design and/or usability of the taxonomy, including proposals for improvement.

We consider that the "do no significant harm" assessment criteria need to be developed further to provide clear definitions and thresholds. As defined currently, it would lead to differing interpretations and therefore inconsistent outcomes. For instance:

- the criteria for the segment Energy Production (Hydro), which could draw differing interpretations;
- in sections 9.1 Afforestation and 9.2 Rehabilitation/restoration and 9.3 Reforestation and 9.4 Existing forest management: the following criterion lacks clarity, "*No conversion of habitats sensitive to biodiversity loss or of high ecological value such as grasslands and any high carbon stock area (e.g. peat lands and wetlands), and areas set aside for the restoration of such habitats".* Absent of further definition it should be expected that these types of criterium are open to varying interpretations and therefore outcomes;
- in sections 10.2 Manufacture of renewable energy equipment and 11.3 Energy Production and in particular "(5) Pollution" reads: "*Select solar PV modules manufactured to the highest environmental standards. Efforts should be made to select the least polluting materials and technology based on life cycle impact assessment."* The current wording makes it difficult to understand what criteria should apply for acceptable material choices.

Such lack of details will lead to even greater challenges when mapping these definitions to a bank's assets, including lending (e.g. for prudential/risk and disclosure purposes), particularly for assets of small and mid-sized clients in the retail and commercial banking bracket. It is therefore important to strike a good balance between sufficient detail/clarity and usability given these types of use cases.

B. 1st ROUND OF CLIMATE MITIGATION ACTIVITIES

Sections 9.1 Afforestation and 9.2 Rehabilitation/restoration 9.3 Reforestation and 9.4 Existing forest management

- Achieving outcomes from the Principle 1 in a credible way likely requires new measurement methodology developments in order to be able to quantify sequestration from combined vegetation and soil with acceptable commercial costs and valid, repeatable methods. Verification of such results would need specialized expertise, above what is currently in use.
- While the inclusion of specific *"do no significant harm"* criteria forms an important part of the assessment, there are instances where these are not concretely defined, e.g. "*No conversion of habitats sensitive to biodiversity loss or of high ecological value such as grasslands and any high carbon stock area (e.g. peat lands and wetlands), and areas set aside for the restoration of such habitats".* Absent of further definition it should be expected that these types of criterium are open to varying interpretations and therefore outcomes.
- Relating to the text: "*Internationally accredited forest certification schemes also have added value in terms of ensuring compliance with some of the "do no significant harm" aspects.".* We would agree that the FSC and PEFC are good minimum standards, but that may not (in reality) prevent negative biodiversity impacts from logging in natural forests, and therefore if the intention is to conserve biodiversity, further additions maybe need to the "*do no significant harm"* criteria.

Section 11: Energy

In reference to pages 10-11, "*An economic activity shall be considered to contribute substantially to climate change mitigation where that activity substantially contributes to the stabilization of greenhouse gas concentrations, […] including through process or product innovation:*
(a) generating, storing or using renewable energy or climate-neutral energy (including carbon-neutral energy), including through using innovative technology with a potential for significant future savings or through necessary reinforcement of the grid".

While included in the definition of climate mitigation activities, the reference to investments in/reinforcements of the grid is not further developed or even mentioned in any of the categories currently included in the draft taxonomy.

In fact, the taxonomy covers the production of renewable energy in various forms, but fails to provide any details on how the distribution of such energy through the grid network, as well as other investments to improve the energy efficiency of the grid, should be treated.

Additionally, it is important to include grid lines to connect renewable energy and improvements to enable renewable energy, but not simply improvements to make grid carrying solely coal/gas generated electricity more efficient.

In addition, the current wording of (5) Pollution which reads: "*Select solar PV modules manufactured to the highest environmental standards. Efforts should be made to select the least polluting materials and technology based on life cycle impact assessment*" makes it difficult to understand what criteria should apply for acceptable material choices.

We would appreciate to get more clarity around these points.

Sections 13.1 and 13.2: Buildings

The taxonomy covers the construction of new buildings and the renovation of existing buildings. However, it is not clear whether the existing stock of houses, if sufficiently energy efficient, can be included in a 'green'

financial product (e.g. green mortgage or a green bond backed by green mortgages). In addition, renovations done piecemeal need to be recognised.

We would agree with the thresholds for the construction of new buildings, but it would also be useful to clarify the thresholds for the existing stock, in line with the comment above. For example, whether houses with energy label A can be included in the taxonomy or future green financial products. In some cases, these houses were built a few years ago and followed the strictest environmental guidelines at the time when they were constructed.

The taxonomy should account for developing standards like the energy efficient mortgage criteria that is being developed by the EMF-ECBC.

Section 13.2: Renovation of existing buildings (residential and non-residential)
The taxonomy proposes that a threshold of 50% reduction in energy consumption or carbon emissions performance should be achieved so that renovation of an existing building is considered as environmentally sustainable. We consider that this threshold of 50% may not achievable and should be recalibrated at a lower level. We recommend that additional evidence should be collected prior to setting an achievable threshold.
In addition, we ask for clarity regarding when to apply a relative performance or an absolute performance target, as the current wording assumes that absolute performance target can only be used for renovation on buildings that are already demonstrating high carbon or energy efficiency.

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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.