Association for Financial Markets in Europe

# AFME position on the EU Taxonomy Regulation

20 June 2019

The EU Taxonomy Regulation ("Regulation") is a foundational proposal of the European Commission's Action Plan on Financing Sustainable Growth ("Action Plan"). We consider that the definition of common sustainability criteria is a significant positive step in an orderly transition towards a low-carbon and climate resilient economy, to which AFME is fully committed.

We agree that lack of clarity as to and complexity around what constitutes "sustainability" is a key obstacle for increasing and directing capital flows towards sustainable investments. Therefore, we welcome the Commission's proposal as we support both the ambitious objectives of the Action Plan and its proposed "step-by-step" approach.

We believe that now there is a strong momentum for market participants, regulators and policy makers to ensure that the taxonomy can become a practical, effective and widely accepted tool to truly encourage the transition of industries to a more sustainable, low carbon economy. We would thus like to contribute to the debates on some of the proposed aspects of the Regulation in pursuit of assisting the co-legislators to make further progress towards reaching agreement on this important file.

On 25 March 2019[1], AFME published its comments on the proposal by the European Parliament on the taxonomy as of 13 March 2019. Notably, the comments provided generally stand true for the text[2] adopted on 28 March 2019 in the Parliament's plenary session (herein, "EP position" or "text adopted by the EP"). We would like to reiterate some of the points made previously and expand our views on the Regulation in the context of the recent negotiations and developments at the European Council commenting on some of the recent proposals by the Romanian Presidency.

## Creating a flexible taxonomy encouraging transition

As noted in our position paper as of 25 March, we agree with the EP position that "the taxonomy should be based on harmonised, comparable and uniform criteria and indicators" taking into consideration the principles of proportionality and progressivity in its application as well as aim to avoid any overlaps in regulation and unnecessary burden of authorities and financial institutions. We generally welcome that the EP position focuses on creating a taxonomy starting with sustainable economic activities only. As noted in our position paper as of 25 March, we believe that creation of a taxonomy for activities with negative environmental impact in the short term would not take into consideration products that might not necessarily comply with the "green" criteria in the nearest future, but which would still contribute to or would be in transition to a more sustainable investing. We also believe that a taxonomy on "brown" activities and respective disclosure requirements would generate financially punitive effects for all companies performing those activities. These firms would be financially discriminated regardless of their benefits brought to society otherwise and regardless of their other measurable contributions to, among others, progressively reducing a negative impact on the environment. However, we regret that the EP proposal rejects industry transition aspects by excluding activities of higher carbon emitting companies by default and **without distinction.**

We believe the taxonomy should recognise companies' proven and measurable **sustainable practices/engagements,** including by companies in sectors that cannot be classified as environmentally sustainable, and **not only economic activities** as such. AFME reiterates that most economic activities, companies and industries are currently at different stages of their pathway towards low-carbon standards and all efforts should be made through the legislative initiatives to support the transition. We therefore believe

[1] https://www.afme.eu/globalassets/downloads/consultation-responses/afme-comments-on-taxonomy-regulation-econ_envi-report_25.03.2019.pdf
[2] http://www.europarl.europa.eu/doceo/document/TA-8-2019-0325_EN.pdf

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that restricting the taxonomy's focus solely to economic activities that are already green could impede the transition and that it is critical to stimulate the allocation of capital to "brown" companies' **transition to environmentally sustainable business models**, subject to such companies being able to demonstrate their commitment to the transition (i.e. reduction of carbon emissions, setting and meeting investment targets for the development of sustainable activities, investment in innovation and R&D, etc.). We believe that it is important to establish a robust, scientific-based and flexible taxonomy that would help create environment for a smooth and orderly move of the EU economy towards more sustainable, low carbon standards and would prevent any large scale divestments especially in companies that have not been able to radically change their business models just yet, for example, due to limitations in technological progress and availability of critical alternatives in companies' production chains. We therefore welcome the Presidency's proposal to create an additional category of transition activities – in order to take activities into account which are not considered sustainable activities according to the taxonomy but are, nevertheless, crucial for the transition towards sustainability**.**

**Definition of an environmentally sustainable investment**

The definition of an environmentally sustainable investment is aligned in the text of the Regulation as proposed by the Commission, the European Parliament and draft compromise proposals by the Romanian Presidency, being "an investment that funds one or several economic activities that qualify under this Regulation as environmentally sustainable". AFME urges the co-legislators to clarify the definition noting that defining environmentally sustainable investment only as a direct capital allocation to sustainable activities might be incomplete as some investment strategies that contribute positively to environmental objectives would be excluded from the definition, for example, ESG structured notes referencing ESG benchmarks where the notes' coupon is indexed to the performance of an ESG benchmark by the benchmark provider purchasing sustainable companies' securities. In this case, the investor funds are allocated to the issuer and not to specific economic activities. Also, investments that fund or reference companies with sustainable practices but that perform activities that are outside of the scope of the taxonomy will not be considered sustainable investments under the existing definition. Therefore, AFME recommends that the definition of 'environmentally sustainable investment' be complemented with the following elements highlighted in bold: "an investment that funds **or references** one or several economic activities or **company practices** that qualify under this Regulation as environmentally sustainable".

**Scope of Regulation**

We understand that proposals by the Romanian Presidency scope in 'financial market participants' as defined by the EU Disclosure Regulation, which limits the scope of credit institutions to those providing portfolio management and investment advice. Notably, the EP Position also included credit institutions under the Capital Requirements Regulation (CRR). We support the alignment of the scope between the EU Disclosure Regulation and EU Taxonomy, in particular with regard to credit institutions. We believe that it is too early to extend the Taxonomy Regulation to essentially any transactions undertaken by a credit institution as defined in CRR (including own portfolios and transactions in a capacity of arranger, underwriter, agent or distributor). We think that appropriate time should be allowed for the market to embrace the taxonomy and develop market practices before any prudential aspects of sustainable finance can be discussed and incorporated in regulation in a meaningful way.

**Alignment of definitions**

Definitions under the Taxonomy Regulation and the Disclosures Regulation should be aligned for legal consistency purpose. We therefore welcome the proposals by the Romanian Presidency referencing the EU Disclosure Regulation for the definitions of 'financial market participant' and 'financial product'.

As outlined in our paper commenting on the EP Position, AFME was concerned that the definition of "financial products" was expanded to include all "issuances" according to Directive 2003/71/EC and Regulation (EU)2017/1129) instead of limiting the issuance scope to green bonds only. We stress that banking institutions distributing securities issued by the corporate sector might not be able on their own to adequately assess and disclose whether the corporate's activities are aligned with the Taxonomy. This is due to the fact that corporates are not included in the definition of a financial market participant per the Regulation and thus would not be obliged to disclose the same level of information necessary for banks to perform the required detailed assessment.

We reiterate our position that a conclusion on whether financial products qualify as environmentally sustainable investments can only be arrived using the information from the issuing investee companies based on the assessment of their sustainable economic activities and/or practices. Notably, there is an increased number of reliable ESG data providers in the market and significant progress in the quality of corporate ESG reporting has been achieved over the past few years. However, there is still lack of availability of ESG data for a wide array of investee companies' activities and/or practices at the level of granularity matching the taxonomy sustainability criteria.

We would be pleased, of course, to discuss the content of this paper or to provide any further clarity with regard to the statements made.

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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.