afme/ Finance for Europe

Association for Financial Markets in Europe

Response to HM Government Update to Green Finance Strategy Call for Evidence

22 June 2022

Introduction

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to respond to the HM Government Call for Evidence on its Update to Green Finance Strategy (the "Call for Evidence"). AFME welcomes the Call for Evidence and the UK's continued commitment to the development of green finance.

AFME's members are committed to supporting the transition to a sustainable economy and strongly support the further development of sustainable finance.

As noted in the Call for Evidence, significant progress has been made towards the objectives of the first Green Finance Strategy. It is important that momentum is maintained and that the Updated Green Finance Strategy outlines clear steps and a timeline to achieve further progress. While progress has been made, further action is needed to facilitate the funding need to support the transition. Globally, a report published by the Global Financial Markets Association (GFMA) has estimated the funding need at $100tn-$150tn over the next three decades to support the decarbonization of ten sectors representing 75% of global carbon emissions.[1] It is therefore crucial that the UK government and regulators continue to focus on putting in place effective foundations to support the growth of sustainable finance and work with their international counterparts to further the vital policy and regulatory work at global level.

It is important to emphasise that alignment of the UK's financial services sector with sustainability goals can only happen as part of a whole of economy transition. This needs to recognise that banks' balance sheets are a reflection of the wider economy. Consequently, a full economy transition requires robust net zero and sustainability policies.

We set out below our reflections on priorities in the context of the Call for Evidence. We also express our support for the response provided by the International Swaps and Derivatives Association (ISDA).

We set out our response below to the following group of questions:

Question 7: How can the UK support a financial system that leverages private investment to meet the UK's climate and environmental objectives?

Question 9: What barriers are there to unlocking private investment to support the UK's energy security, climate and environmental objectives?

Question 11: How can the UK best facilitate greater private investment into climate change adaptation and resilience activities?

1 Climate Finance Markets and the Real Economy, GFMA and BCG, December 2020

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Question 12: Are there barriers to the mobilisation of private investment into transition activities? If so, what are they and how might they be overcome?

The Government needs to provide a robust, clear and coherent regulatory framework across the real economy, sector by sector, to support the changes brought forward by the financial sector. In order to facilitate the further development of private investment to support the UK's climate and environmental objectives, as set out in AFME's report Sustainable Finance in Europe: Regulatory State of Play[2], we have identified three priority areas of focus for further development:

(1) Finalising effective foundations for the regulatory framework;

(2) Ensuring coherence and consistency of the framework as a whole; and

(3) Strengthening international coordination.

The foundations of the regulatory framework include key building blocks such as (a) developing a disclosure framework for sustainability reporting; (b) providing a common classification system of economic activities contributing to sustainability objectives through establishing a Taxonomy; and (c) ensuring that sustainability risks are effectively integrated into risk management.

The building blocks of sustainability disclosures and the development of a Green Taxonomy should form key enablers of the financial sector's role in mobilising capital to support the transition to Net Zero. Progress has been made and work is already currently under way in each of these areas, including as set out in the government's Roadmap for Greening Finance and the extensive work by the Bank of England and PRA on integrating climate risk into their supervisory framework. We expand briefly upon each of these priorities below.

Establishing sustainability disclosure requirements

As has been widely recognised, an important barrier to private investment in support of environmental objectives is the availability of high quality, comparable and reliable sustainability data. We welcome the government's plans to establish an integrated framework for Sustainability Disclosure Requirements, building upon the requirements for TCFD reporting.

It is important that the Government proceeds to put this in place in a timely manner. Well designed and appropriately sequenced Sustainability Disclosure Requirements are essential to ensure that financial institutions and investors have the necessary data to allocate capital to support transition plans, and for their own disclosures and risk management. Improved quality and consistency of ESG data is also a vital tool to help combat greenwashing and improve the quality and comparability of ESG ratings.

We welcome the UK government's support for the establishment and work of the International Sustainability Standards Board (ISSB). The government should build upon the common baseline standards under development by the ISSB, ensuring consistency and compatibility between the UK and international standards.

As the SDRs are developed, it is essential to ensure that there is appropriate sequencing of disclosure requirements reflecting the needs of financial institutions to receive data from their clients in order to accurately reflect these in their own disclosures.

[2] https://www.afme.eu/Portals/0/AFME_SustainableFinance2021_06.pdf?ver=2021-11-22-080352-217

We encourage the government to consider how it can leverage technology to enhance the usability of sustainability data[3]. For example, we welcome the proposal in the proposed EU Corporate Sustainability Reporting Directive (CSRD) specifying the format for reporting and require companies to categorise this information according to a digital system to be developed alongside the sustainability reporting standard. Digitalisation of sustainability data has the potential to reduce reporting costs, improve ease of access to information and support comparability.

Finalising the Green Taxonomy

The work underway to operationalise the Green Taxonomy is another important foundation to provide a science-based framework for classification of environmentally sustainable activities.

It is important to maximise the usability of the Taxonomy and that associated disclosure requirements provide useful, comparable information and are integrated and the timing appropriately sequenced between requirements for the financial and non-financial sectors.

The government should aim to minimize fragmentation and support global capital markets by reflecting on experiences with the EU Taxonomy as well as ongoing work by the International Platform on Sustainable Finance. It will also be important to take into account the recommendations of the Global Financial Markets Association (GFMA) Global Guiding Principles for Developing Climate Finance Taxonomies[4]. Consideration should also be given to expanding the taxonomy to better cover transitional activities and enhance the coverage of activities across economic sectors.

While maintaining as much consistency as possible to avoid fragmentation, the UK Government should also take into account market feedback on some of the complexities and usability challenges with respect to the implementation of the EU Taxonomy. Some of these include:

- an overly prescriptive Do No Significant Harm (DNSH) approach, compounded by a lack of available granular data, means that it is very challenging to demonstrate Taxonomy alignment; and
- the introduction of the Green Asset Ratio (GAR) through Article 8 of the EU Taxonomy Regulation poses both operational challenges for banks to report and is potentially misleading for investors. This is primarily because the ratio (the denominator) refers to total assets, includes asset classes that will never be covered by the Taxonomy's criteria, while the numerator refers to eligible assets. In essence, there is a mismatch between the numerator and denominator. Therefore, the resulting reportable metrics are primarily driven by the operating model of the bank, rather than accurately highlighting taxonomy aligned financing activities.

Ensuring a coherent regulatory framework

As this work on the regulatory framework is taken forward, we call on policymakers and regulators to carefully consider the coherence of the framework as a whole to ensure that it is meeting its goals of facilitating the allocation of investment to meet sustainable objectives, avoids undue complexity and overlapping, duplicative or inconsistent requirements. Further enhancing the consistency, understanding and usability of the framework would facilitate its implementation and help support well-functioning sustainable finance markets.

[3] As also proposed in the Kalifa Review of UK Fintech report, February 2021
[4] https://www.gfma.org/correspondence/unlocking-the-potential-of-carbon-markets-to-achieve-global-net-zero/

We also encourage the Government to publish a sustainability initiatives grid, similar to the Regulatory Initiatives Grid published by the Financial Services Regulatory Initiatives Forum[5]. This would bring together current and upcoming initiatives by the Government, regulators and relevant bodies such as the Transition Plans Taskforce across sectors, aiding navigation and planning.

Providing clear sectoral pathways

Alongside sustainability disclosures and the development of a Green Taxonomy, businesses, banks and investors need a clear roadmap for the economy-wide transition to a low carbon economy, enabling them to design and assess credible and effective strategies in support of the transition.

Governments play an essential role in bringing clarity and legal certainty in the market as to the long-term strategy to de-carbonise the economy. Businesses and investors alike would benefit from intermediate milestones for each sector, consistent with the 2050 targets and the economy's capabilities. This is a critical component to facilitate real economy transition plans and the finance associated with meeting them.

Sectoral pathways should also be reflected in the classification of environmentally sustainable economic activities under the Green Taxonomy. This also plays a role in bringing clarity to the market and we believe that the Green Taxonomy should embed transition considerations to facilitate the funding of activities transitioning to sustainability. Taxonomies ought to be reviewed regularly to ensure that the threshold criteria remain aligned with transition pathways and reflect technological developments. Ensuring that reviews happen at regular intervals and that criteria are tightened according to a clear, pre-defined roadmap will contribute to defining clear sectoral pathways.

Market participants use ESG targets to develop a broad range of financing solutions to unlock capital for companies in transition. Similar KPIs are also used to measure progress towards reaching the investments' objectives. Clear sectoral pathways will can bring the confidence in the market to significantly scale up financing, including in infrastructure and towards SMEs.

In addition to sectoral pathways, we support the Government's initiative to establish the Transition Plans Taskforce to create a framework for private sector transition plans. Introducing a requirement for companies across the economy to publish transition plans would be beneficial in providing investors and financial institutions with valuable data, facilitating transition finance. Crucially we consider that these rules should apply to both listed and private companies on a proportionate basis akin to the roll out of Task Force on Climate-Related Financial Disclosures (TCFD) across the UK.

International leadership and cooperation

AFME strongly supports the UK Government continuing to seek progress at the international level, demonstrating international leadership and seeking to maximise the international consistency of approaches including to taxonomies and reporting standards.

[5] https://www.fca.org.uk/publication/corporate/regulatory-intitiatives-grid-may-2022.pdf

Question 6. What areas for potential growth – for example emerging financial products and instruments – are there in green finance for the UK financial services sector?

Securitisation is a tool that has been broadly used outside Europe to finance the green transition. The US green securitisation market is over 10 times larger than the European market and constitutes c.50% of the overall US green bond market (vs. 1% in Europe). China has also seen rapid growth in green Securitisation, and makes up 11% of the green bond market. Securitisation is a natural vehicle to finance the transition for both the consumer and corporate sector. Both consumer and corporate lending is facilitated through private and public securitisations either collateralized by green auto leases / loans or mortgage loans or whose proceeds are used to finance these assets to consumers, SMEs, mid-caps or large corporates across a broad range of industries.

However, there is still more work to do to help make the European (including the UK) market more attractive and user-friendly for investors. Clear definitions, more political support and regulatory and financial incentives, and establishing green eligibility criteria for green securitisation transactions are the key factors contributing to the future growth of the green securitisation market.

Question 15: How can the UK best support the mobilisation of private investment to natural capital assets?

AFME welcomes the Government's emphasis on the importance of addressing nature and the decline in biodiversity alongside climate change and its support for the Taskforce on Nature-related Financial Disclosures (TNFD). We see the mobilisation of private investment into natural capital assets as an important priority and an opportunity where significant progress is needed to meet the current funding gap. The UK can support this objective by ensuring alignment with international definitions / markets, including alignment with approaches such as the TNFD and supporting coherence across reporting and disclosure requirements. Please also see our response to question 22 below regarding the role that voluntary carbon markets can play in protecting and restoring biodiversity and natural ecosystems.

AFME is currently developing a report considering opportunities for scaling finance in support of biodiversity and nature positive objectives which we will share once it is published.

Developing carbon markets

In October 2021, GFMA published a report with Boston Consulting Group, "Unlocking the Potential of Carbon Markets to Achieve Global Net Zero"[6]. The report highlights the role and importance of both compliance and voluntary carbon markets in the transition to a low-carbon global economy. It provides an overview of the carbon markets ecosystem, highlights key challenges, and outlines recommendations for policymakers, market participants, and other key stakeholders to scale deep and liquid global carbon markets, while highlighting key enablers and dependencies. The report emphasises the need to scale and further enhance emissions trading schemes and makes a number of recommendations including enhancing geographic and sectoral coverage coupled with more aggressive decarbonisation ambitions aligned with the Paris Agreement.

It also highlights the importance of a clear complementary role for voluntary carbon markets (VCM). To strengthen trust in the VCM, and to enable it to grow from the current scale it is critical to develop stringent and transparent baselines and Measurement, Reporting, and Verification (MRV) standards to ensure verifiable

[6] https://www.gfma.org/correspondence/unlocking-the-potential-of-carbon-markets-to-achieve-global-net-zero/

"additional" emissions reductions, and robust evaluation of whether MRV standards are met by third-party certifiers. These standards should also regularly be strengthened and made more stringent to ensure that VCM projects remain additional. This would be supported by the work of the Integrity Council for the Voluntary Carbon Market (ICVCM) and Voluntary Carbon Markets Integrity Initiative (VCMI) to develop market consensus on the role of VCM credits, a consistent taxonomy of additional attributes such as co-benefits to biodiversity and socio-economic development, and harmonized MRV standards and registries.

The report also considers the opportunities for enhancing interoperability (1) among ETSs with similar rates of decarbonization and similar pathways and (2) between ETSs and the VCM through tightly controlled mechanisms. Greater interoperability would serve to grow carbon markets while driving additional co-benefits.

Question 22. How can the UK best support the development of high integrity voluntary markets for carbon and other ecosystem service markets?

The UK can lead the development of carbon markets to build on the welcome progress made at COP26 on Article 6 of the Paris Agreement – both by working to put an effective price on carbon and to reallocate revenues – for example, by hypothecating revenues from the sale of carbon permits for investment in new technologies.

The government should recognise the role of voluntary carbon markets in its Net Zero strategy and consequently in individual corporate strategies. The most recent IPCC assessment (Sixth Assessment Report (AR6) – last instalment[7]) is clear that countries need to immediately and dramatically reduce their greenhouse gas emissions and remove CO2 from the atmosphere. This lays down the scientific basis for the need to remove carbon from the atmosphere alongside robust efforts to reduce/prevent future carbon emissions. High integrity voluntary carbon markets can play an important role by helping channel private finance into scaling projects and solutions for carbon removal (both technology-based and nature-based).

The government should also encourage organisations to mitigate the impact of their GHG emissions while on the journey to achieving Science Based and time limited carbon reduction. We would also like to highlight the important role that VCM can play in protecting and restoring biodiversity and natural ecosystems due to the dual benefits of nature-based carbon credits and the emergence of biodiversity credits.

The UK should progress with the implementation of the Article 6 Paris Agreement framework at the UK level. A clear legal framework will help establish an operating model for the voluntary carbon markets in the UK, including confidence and more consistent practice around the use of carbon credits by individual market participants.

Question 23. How can we ensure that these markets encourage robust action on the UK's climate and environmental goals, and appropriately scale up finance flows to support these?

Integrity of global voluntary carbon markets has to date been the major impediment in scaling these markets. This issue has been widely acknowledged and high profile multi-stakeholder initiatives have been set up to help establish frameworks and governance processes, such as the ICVCM (with global remit) and the Voluntary

[7] https://www.ipcc.ch/report/sixth-assessment-report-working-group-3/

Carbon Markets Integrity Initiative (VCMI) (focusing on the UK). Both ICVCM and VCMI are working to produce principles and guidance that would allow market participants to determine attributes that credible carbon credits should possess and how carbon credits can support sustainability strategies set by companies operating in different sectors and industries. The UK government can work to endorse the recommendations of these market wide initiatives.

UK national standard setting bodies should continue to ensure that any approach taken locally is consistent with global standardization efforts, such as those undertaken by ICVCM. In this regard, we support the ICVCM in its work to increase market confidence in the quality of voluntary carbon credits and address market participants' concern related to environmental and reputational risks associated with trading voluntary carbon credits.

We support the work of the UK Voluntary Carbon Markets Forum (VCM) that will implement the framework recommended by the ICVCM, and thus ensure that UK-based firms and branches of global firms based in the UK possess critical tools in corporate emission reduction efforts. Providing legal certainty regarding the treatment of carbon credits under English law is also instrumental to establishing the UK as a carbon-trading hub.

Question 24. How should the UK harness the economic opportunities associated with high integrity growth in voluntary carbon markets and ecosystem services markets?

Please refer to our response to Q22. Once the market structure for credible VCM is established, the UK government should consider convergence/interoperability of regulated schemes (EU ETS) and VCM – potentially running pilots for certain industries. The GFMA report discussed above highlights the opportunities and considerations for enhancing interoperability of regulated and voluntary carbon markets. As highlighted in the GFMA report, it would be important to ensure that it is only the carbon credits of high quality that would be allowed for application in the regulated schemes.

Question 25. How can UK environmental and economic regulators increase demand for high quality, accredited ecosystems services?

There is already high demand for high quality, accredited ecosystems services – and high quality carbon credits. The issue is on the supply side. The supply can be further boosted once the government is able to provide market signals about the role of carbon credits and VCM in net zero strategies, as per the above recommendations. Currently, nature-based project developers often face constraints in attracting finance at scale due to uncertainties associated with government policies and legislation on the use of carbon credits. Establishing governance frameworks (though ICVCM and VCMI), whilst increasing compliance costs initially, would also help facilitate the formation of high quality ecosystems services in the medium- to longer-term. In the longer term, supervision of some service providers may need to be established (similar to the direction of travel being taken now with regard to ESG rating providers).

Separately, the UK government may consider working with the private sector to co-invest in technological solutions, including their scaling, helping to more accurately measure CO_2 removal capabilities of nature-based projects as well as solutions to monitor the operationalisation of such projects.

If you have any questions or would like to discuss further, please contact:

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About AFME

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.[8]

[8] AFME is the European member of the Global Financial Markets Association (GFMA) 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) in Asia. AFME is registered on the EU Transparency Register, registration number 65110063986-76.