AFME and ISDA position on the review of the EU ETS

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The EU Emissions Trading System (ETS) is the cornerstone of the EU's climate policy and its most important market-based instrument for reducing greenhouse gas emissions cost-effectively. By putting a price on carbon, it provides a transparent and technology-neutral signal that guides investment, innovation and industrial transformation across covered sectors. Its effectiveness and ability to mobilise private capital depend on the credibility of that signal and on the deep, well-functioning market in which it is formed.

The Association for Financial Markets in Europe (AFME), the International Swaps and Derivatives Association (ISDA) and their members support an ETS review that preserves the integrity of the carbon price signal and the predictability of the framework, while strengthening the system's contribution to European industrial decarbonisation, energy security and competitiveness. The review should ensure that ETS revenues and related instruments are deployed in a way that mobilises private capital.

AFME and ISDA represent banks, other wholesale market participants and derivatives market users that provide and rely on hedging, liquidity and financing in the carbon market. Our members also represent a critical source of capital to the real economy by supporting the investment needed for decarbonisation and climate resilience. Our key priorities for policymakers as they consider the Commission's proposal are summarised below and set out in more detail in the rest of this paper.

- **Predictability:** keep changes to the framework, including the Market Stability Reserve (MSR), predictable and consistent with its objectives, and provide early clarity on the rules that will apply after 2030.
- **Market functioning:** avoid new barriers to the participation of financial intermediaries beyond the safeguards already in place, such as the proposed transaction fee on secondary market activity, which would ultimately raise costs for compliance entities.
- **EU-UK linking:** confirm an early timeline for linking the EU and UK emissions trading systems, and avoid design choices in the review that would complicate it.
- **Investment:** ensure that ETS revenues and the Industrial Decarbonisation Bank are used to crowd in private capital, and that any requirements attached to free allocation reflect what companies can realistically deliver.
- **Domestic removals:** set out a clear pathway to move from centralised purchasing towards direct use of certified removals by regulated entities, making them a tradable instrument over time.
- **Additional removal pathways:** make biochar eligible from the outset and bring forward the assessment of nature-based removals, subject to robust safeguards.
- **International credits:** set out early, transparent criteria and a clear timeline for integrating high-integrity international credits aligned with Article 6 of the Paris Agreement.
- **ETS2:** maintain the agreed timeline and confirm it as soon as possible.
- **Coherence:** ensure consistency between the ETS and the Carbon Border Adjustment Mechanism (CBAM), including on the use of international credits.

1. Preserving a predictable framework and a credible carbon price signal

It is vital to maintain the credibility of the price-signalling function of the ETS. A stable, market-based and predictable framework is essential if the system is to continue providing the carbon price signal needed to drive long-term investment, innovation and emissions reductions across covered sectors. Changes to the framework should be made only where there is a clear need, and should remain consistent with the original objectives of the mechanisms concerned. They should follow clear, predefined criteria, be transparent and be signalled well in advance, so that market participants can reflect them in their expectations and investment decisions.

The same principles should apply to the MSR. Safeguarding market stability is a legitimate objective, and it is best served by stable, transparent rules on the withdrawal and release of allowances, which give market participants confidence that prices are determined primarily by market fundamentals. Uncertainty over future allowance supply makes participants more reluctant to commit capital to long-dated hedging, market-making and liquidity provision, and frequent recalibration of the reserve would add policy-induced volatility. A stable framework for the reserve would instead support reliable long-term price expectations, deeper forward and derivatives markets, lower hedging costs for compliance entities and a stronger carbon price signal.

Clarity on the framework beyond 2030 is equally important. Investment and hedging horizons for compliance entities already extend well beyond the current trading period, and uncertainty over the rules that will apply raises the cost of capital for transition projects. Early clarity on the post-2030 framework would reduce this risk and improve the bankability of decarbonisation investments.

2. A deep and liquid market underpins the ETS

Financial institutions are essential to the effective functioning of the ETS. Most compliance entities, in particular utilities and industrial firms, manage their carbon exposure through forwards, futures and options, often several years ahead of surrender, and rely on banks to provide that hedging capacity. Market makers provide the liquidity that allows compliance buyers to transact efficiently, and financial institutions participate in primary auctions on behalf of smaller emitters that lack direct access. This supports robust price discovery and lowers the cost of compliance.

A deep and liquid secondary market is therefore integral to the credibility of the carbon price signal that the review seeks to preserve. The expertise banks develop in pricing and managing carbon risk also informs their lending and investment decisions, helping to mobilise capital towards low-carbon projects.

The safeguards needed for the participation of financial intermediaries in the ETS are already in place. Emission allowances and their derivatives are already regulated as financial instruments under MiFID II, and are subject to the requirements of MAR and EMIR. In addition, ESMA closely monitors the functioning of the market, and its analysis has consistently found that price developments are largely driven by underlying market fundamentals. AFME and ISDA therefore caution against measures that would restrict participation by financial market participants or increase the cost of trading. Such measures would risk reducing market liquidity, widening bid-offer spreads and ultimately raising costs for the compliance entities that the EU ETS is intended to serve.

In particular, AFME and ISDA do not support the introduction of a transaction fee on secondary market activity in emission allowances, as envisaged in the review clause included in the

European Parliament's position on the Temporary Decarbonisation Fund.[1] We are particularly concerned about amendments tabled in the European Parliament to the ETS review that would go even further, inserting a similar review clause into the ETS Directive itself, without any exemption for transactions undertaken for compliance purposes. The mere prospect of a transaction fee creates regulatory uncertainty and undermines the predictability of the carbon pricing framework, which is essential for effective investment and risk-management decisions. By increasing the cost of participation in EU carbon markets, such a measure would discourage market activity. Compliance entities could be forced to scale back long-term hedging and investment strategies, while financial intermediaries may reduce their services to compliance firms or withdraw from the market altogether.

Moreover, an exemption for transactions undertaken solely for compliance purposes would not prevent the associated costs from ultimately being borne by compliance entities. A transaction fee would make hedging more costly and operationally complex, reduce market liquidity, and make it more difficult to find counterparties. In turn, this would increase the cost of managing carbon-price risk and planning investments in low-carbon technologies. These additional costs would inevitably be passed through the value chain, ultimately leading to higher costs for European businesses and consumers alike.

3. Mobilising private investment for industrial decarbonisation

AFME and ISDA strongly support the proposal's objective to substantially increase investment in the EU's energy system and industry, contributing to energy security and decarbonisation targets. The ETS review should work hand in hand with the Clean Industrial Deal to support the decarbonisation and competitiveness of European businesses, and ETS revenues should be used to support the investments needed for decarbonisation and enhanced climate resilience.

We welcome the activation of the Industrial Decarbonisation Bank (IDB), including its first phase through the ETS Investment Booster, which is expected to provide €30 billion of investment between 2028 and 2030. The current design of the Investment Booster, including the ex-post allocation of allowances rather than frontloading, should be preserved to support investment while safeguarding EU ETS market integrity. The IDB should work together with private financial institutions to maximise its catalytic impact, crowding in private financing through the use of de-risking structures.

We recognise the objective of linking continued free allocation to decarbonisation investment plans. However, companies' ability to deliver decarbonisation investment depends on enabling conditions that are often outside their control, including supportive policies and incentives, adequate infrastructure and grid connections, competitive energy costs, suitable technologies and demand for low-carbon products. Any requirements attached to free allocation should therefore reflect what companies can realistically deliver, particularly in hard-to-abate sectors where technically and economically viable decarbonisation options may not yet be available. Clear requirements and implementation timelines would support investment planning by companies and their financial counterparties, while preserving the primary role of free allocation in preventing carbon leakage.

1 The European Parliament's negotiating mandate calls on the European Commission to undertake a comprehensive assessment by 31 March 2028 and, where appropriate, submit a legislative proposal by 31 December 2028 introducing such a transaction fee.

4. Making domestic carbon removals a tradable instrument to mobilise private capital and support innovation

AFME and ISDA welcome the integration of permanent carbon removals into the ETS, including bioenergy with carbon capture and storage (BioCCS) and direct air carbon capture and storage (DACCS), with a gradual phase-in and robust certification, monitoring, liability and reversal rules. These reflect the approach we recommended in our joint response to the Commission's consultation.[2]

However, under the proposal, the Commission would act as the sole purchaser of removals, which would be cancelled on purchase. We recognise that centralised purchasing may be needed in an initial phase. Over time, however, regulated entities should be able to purchase certified removals directly from suppliers and surrender them for compliance, within the limits and safeguards set by the framework. A tradable removals instrument would support market-based price discovery, give removal developers access to a wider pool of buyers and to forward offtake and hedging arrangements that improve project bankability, and mobilise private capital to scale removal technologies while reducing reliance on public purchasing.

Direct tradability alone may not be sufficient to generate demand. Where removals cost more than EU allowances but carry the same compliance value, regulated entities have limited incentive to purchase them. The framework should therefore also consider complementary measures, such as contracts for difference, to bridge this price gap and support the long-term offtake agreements needed for project financing. Such measures should be based on realistic assumptions about removal costs and supply, facilitate private participation and preserve the environmental integrity of the EU ETS.

The framework should provide a clear pathway towards direct use of removals by regulated entities. During the initial phase, the Commission should draw on existing specialist market intermediaries and service providers in designing and executing procurement. At the same time, eligibility should remain anchored in the Carbon Removals Certification Framework (CRCF), which should provide the primary basis for determining whether removals are suitable for use within the EU ETS, complemented by the additional safeguards for non-geological removals set out in section 5. Additional market tools and services, such as risk assessments, due diligence, insurance and other risk-management mechanisms, may help support disciplined purchasing and manage delivery and reversal risks, where appropriate. Such tools could facilitate market participation and help attract private capital without creating duplicative standards or eligibility requirements.

5. A risk-based approach to additional removal pathways

We encourage the Commission to consider a broader range of removal pathways, including nature-based removals, with safeguards that reflect their different characteristics and risks. Biochar and other non-geological permanent removals should be eligible from the outset, within a clear quantitative limit and subject to a strict integrity threshold beyond certification. Certification methodologies for biochar carbon removal have already been adopted by the Commission under the CRCF. Performance, delivery and reversal risks should be independently assessed and mitigated; units that do not meet the threshold should be excluded. The Commission's assessment of whether nature-based removals could be integrated should also be brought forward from 2034, giving investors earlier clarity on the potential scope of the market and supporting investment in high-quality nature-based removal projects.

2 AFME and ISDA response to the European Commission public consultation on the EU ETS and MSR

6. A role for high-integrity international credits

AFME and ISDA support a carefully designed role for high-integrity international credits, as envisaged under the EU's 2040 climate target. Credits should meet robust standards aligned with Article 6 of the Paris Agreement, including corresponding adjustments, and be subject to clear quantitative limits and transparent governance. Timing, volumes and the mechanism for integration should be set out well in advance, so that market participants can price them and the carbon price signal is not diluted unexpectedly. Well-designer international credits can lower transition costs, mobilise private finance for decarbonisation in third countries and support the development of global carbon markets.

The Commission should set out the specific eligibility criteria at an early stage; these should safeguard integrity without unduly constraining the supply of eligible high-quality credits.[3] It is also important to provide clarity on how the availability and cost-effectiveness of international credits will be assessed, on the Commission's price assumptions for the 2036 to 2040 period, and on the arrangements for transferring unused allowances to the Industrial Decarbonisation Bank. Decisions on the use of international credits should be based on objective and transparent criteria, so that market participants can assess the effectiveness of the mechanism and reflect it in their expectations. To further support the uptake of international credits, the co-legislators should also consider whether CBAM declarants could use eligible international credits towards their CBAM obligations, subject to the same integrity standards and limits.[4]

7. Certainty on the ETS2 timeline

The review should not reopen the agreed timeline for the emissions trading system for buildings, road transport and additional sectors (ETS2), and the co-legislators should confirm it as early as possible. Maintaining the timeline would give regulated fuel suppliers, investors and other market participants the certainty they need for hedging, long-term planning and financing decisions. It would also strengthen the business case for low-carbon investments in these sectors, which depends on a clear and credible expectation of when carbon pricing will apply.

8. Linking the EU and UK emissions trading systems

AFME and ISDA support the ambition of the EU and UK to link their emissions trading systems. An early confirmation of the timeline for linking would give market participants the certainty they need to prepare. A linked market would deepen liquidity, improve price discovery and reduce compliance costs for firms active in both jurisdictions, while enabling mutual exemptions from CBAM. The ETS review should avoid design choices that could complicate future alignment. Any linkage framework should ensure fungibility between allowances, provide robust clearing and settlement arrangements, preserve environmental integrity, and minimise disruption to existing hedging, risk-management and investment activities, supported by clear and predictable communication to the market.

9. Policy coherence

Coherence between the ETS and related instruments, including CBAM, is vital. This includes a consistent approach to the recognition and use of international credits. Any misalignment

3 ISDA and AFME response to the European Commission's consultation on a Legal Framework for the possible use of international carbon credits towards the 2040 EU climate law target

4 ISDA Responds to EC Consultation on Calculation of Carbon Price Paid in a Third Country

risks creating regulatory uncertainty, which could ultimately weaken long-term investment signals.

Conclusion

A predictable, well-functioning ETS is indispensable to achieving the EU's climate objectives while supporting investment, competitiveness and energy security. AFME, ISDA and their members stand ready to engage with the co-legislators and to share their practical expertise on how the carbon market functions as the review is taken forward.

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