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UPDATE ON EUROPEAN TECHNICAL EXPERT GROUP (TEG) ON SUSTAINABLE FINANCE & ON EU SUSTAINABLE FINANCE LEGISLATIVE INITIATIVES

Background

Following the publication in March 2018 of the Action Plan on sustainable finance of the European Commission, the Technical Working Group on Sustainable Finance (TEG) was established in June 2018. **ICMA, with the support of the GBP SBP Executive Committee, was nominated on the TEG following a highly selective process**. The TEG has held monthly working group and plenary meetings since its inception and its mandate has now been extended until the end of 2019.

The TEG published on 18 June 2019 reports and guidelines relating to its 4 key deliverables:

- EU Taxonomy for sustainable activities
- EU Green Bond Standard
- EU climate benchmarks and benchmarks' ESG disclosures
- Guidelines on the disclosure of environmental and social information

This paper provides an overview and comments on these reports. It also provides in Annex 1, an update on the parallel EU legislative initiatives on sustainable finance that are under way reflecting the Commission's legislative proposals of May 2018.

I Taxonomy

Comment: *the new report aims to take on board market and stakeholder feedback from the first consultation end 2018 that identified issues relating among other to (i) technical sustainability criteria seen as potentially too binary, rigid and/or EU centric, (ii) lack of clarity on how transition and impact would be taken into account, (iii) usability for the green bond market and green finance generally. The report reflects progress on all these fronts and also clarifies the proposed application of "Do No Significant Harm" (DNSH) criteria based especially on EU environmental legislation which may however reinforce the perception of EU centricity of the Taxonomy. A new consultation will take place over the summer which will give the market the opportunity to provide further input. It will also be important to monitor how the European Council and Parliament may seek to amend the Taxonomy's configuration and methodology (through the related legislative discussions, see Annex 1) as complementary approaches have been reportedly considered.*

The report on the EU Taxonomy for sustainable activities sets out the basis for a future EU Taxonomy in legislation (See Annex 1). The report also aims to help investors and other potential users to start to understand the implications of the Taxonomy. The report contains:

- Technical screening criteria for 67 activities that can make a substantial contribution to climate change mitigation across the sectors agriculture, forestry, manufacturing, energy, transportation, water and waste, ICT and buildings. Almost all activities have also been assessed for significant harm to other environmental objectives.
- A methodology and worked examples for evaluating substantial contribution to climate change adaptation.
- Guidance and case studies for investors preparing to use the Taxonomy.

The report identifies three kinds of activity can make a substantial contribution to climate change mitigation. These are:

> 1) Activities that are already low carbon. These activities are already compatible with a 2050 net zero carbon economy. Examples include zero emissions transport, near to zero carbon electricity generation and afforestation.
> 2) Activities that contribute to a transition to a zero net emissions economy in 2050 but are not currently operating at that level. Examples include electricity generation <100g CO_2/kWh or cars with emissions below 50g CO_2/km.
> 3) Activities that enable those above. For example, manufacture of wind turbines or installation of highly efficient boilers.

The report illustrates how the “Do No Significant Harm” (DNSH) criteria” may be applied through additional screening criteria proposed by the TEG. These contain quantitative thresholds where possible. Where this is not possible, the criteria are qualitative, describing an action or set of actions to be demonstrated which avoid significant harm.

The baseline scenario is compliance with relevant EU environmental legislation. To this end, the criteria reflect existing EU legislation. The call for additional expertise to inform the TEG and a dedicated process enabled the establishment of criteria based on available scientific evidence. Where evidence was not conclusive, the precautionary principle enshrined in article 191 TFEU was taken into account, as required in Article 14 of the draft regulation.

To the extent possible, the screening criteria, whether qualitative or quantitative, were selected to facilitate the verification of compliance. In many instances, the proposed criteria are expressed in terms of compliance with relevant EU legislation and/or associated reference information, such as the best available techniques (BAT) reference documents (also known as ‘BREFs’).46

The TEG’s work on the Taxonomy will continue until year end and will focus especially:

- Refining and further developing some incomplete aspects of the proposed technical screening criteria for substantial contributions and avoidance of significant harm.
- Exploiting the additional feedback from the planned summer consultation.
- Developing further guidance on implementation and use of the Taxonomy.

II EU Green Bond Standard

Comment: *the June report remains very close to the original version released in March and retains the proposed voluntary key features of the EU GBS (i.e. formalised Green Bond Framework, mandatory verification, reporting including impact, comprehensive definition of use of proceeds and alignment with EU Taxonomy) and explicitly references current best market practices as represented by the GBP. It is more specific on reporting requirements (that are simplified) and on what is subject to external verification (the Green Bond Framework and the allocation Report). Certain recommendations regarding direct support to market participants (e.g. subsidies for external reviews and guarantees for non-investment grade issuers) are given less prominence. The proposal for a market based interim initiative relating to external reviewers is also recast as a registration rather than an accreditation scheme to describe more accurately the scope of what can be established before the proposed supervision by ESMA is in place.*

The report on the EU Green Bond Standard proposes that the Commission creates a voluntary, non-legislative EU Green Bond Standard designed to enhance the effectiveness, transparency, comparability and credibility of the green bond market and to encourage the market participants to issue and invest in EU green bonds.

1. Alignment with EU-taxonomy: proceeds from EU Green Bonds should go to finance or refinance projects/activities that (a) contribute substantially to at least one of the six taxonomy Environmental Objectives, (b) do not significantly harm any of the other objectives and (c) comply with the minimum social safeguards. Where technical screening criteria have been developed, financed projects or activities shall meet these criteria, allowing however for specific cases where these may not be directly applicable.
2. Publication of a Green Bond Framework, which confirms the voluntary alignment of green bonds issued with the EU GBS, explains how the issuer's strategy aligns with the environmental objectives, and provides details on all key aspects of the proposed use-of-proceeds, processes and reporting of the green bonds.
3. Mandatory reporting on use of proceeds (allocation report) and on environmental impact (impact report).
4. Mandatory verification of the Green Bond Framework and of the allocation report by an external reviewer.

The TEG recommends that external verifiers are formally accredited and supervised. The TEG argues that the most suitable European authority to design and operate such an accreditation regime for verifiers would be the European Securities and Markets Authority (ESMA). As this will take time, the TEG calls for the set-up of an interim registration process for external verifiers of green bonds, for a transition period of approximately three years, in close cooperation with the EC.

The TEG lists six additional preliminary recommendations on how the EC, EU Member State governments and market participants can support of the uptake of the EU GBS through both demand and supply-side measures. It recommends widespread adoption by the official sector and calls especially for the “European System of Central Banks (ESCB) and the members of the Network for Greening the Financial System (NGFS) consider promoting greening the financial system by expressing and implementing a preference for EU Green Bonds when purchasing green bonds”.

III Benchmarks

Comment: *Following the political agreement reframing of the TEG benchmark workstream in February 2019, the June report attempts to provide answers to the methodological challenges of implementing the proposed EU Climate Transition Benchmark and the EU Paris-Aligned Benchmark. The report expressly recognises that no “established framework has yet emerged for measuring the alignment of an investment portfolio with a temperature scenario”. The feedback from the new consultation launched in parallel will be critical to judge market sentiment on the near-term feasibility of what is being proposed.*

The TEG report on EU climate benchmarks and benchmarks' ESG disclosures sets out the methodology and minimum technical requirements for indices that will enable investors to orient the choice of investors who wish to adopt a climate-conscious investment strategy and address the risk of greenwashing. Several criteria must be met to qualify as an EU Climate Transition Benchmark (EU CTB) or an EU Paris-Aligned Benchmark (EU PAB).

Specifically, climate benchmarks must demonstrate a significant decrease in overall GHG emissions intensity compared to their underlying investment universes or parent indices. This assessment must gradually integrate Scope 3 emissions (i.e. indirect emissions from an organisation’s value chain) during a four-year period for sectors where the impact on climate change is significant but located outside of direct operational boundaries (such as Oil & Gas and transport). This minimum relative decarbonization is set at 30% for EU CTBs and 50% for EU PABs.

Climate benchmarks must be sufficiently exposed to sectors relevant to the fight against climate change. In other words, decarbonization cannot happen through a shift in the allocation from sectors with high potential impact on climate change and its mitigation (e.g. energy, transport, manufacturing) to sectors with inherently limited impact (e.g. health care, media).

Regarding the requirement to disclose an assessment of ‘Paris alignment’ for each benchmark, the TEG recognises that no broadly accepted and established framework has yet emerged for measuring the alignment of an investment portfolio with a temperature scenario. Hence, in the interim report, the aim is to address specific elements of the emerging market practice of measuring the Paris alignment of investment portfolios

In parallel with the release of the climate benchmarks report a 6 weeks call for feedback was launched. With the benefit of the feedback received the TEG is expected to publish the final version of the report by the end of September.

IV Disclosures

Comment: *The proposed guidelines represent an important endorsement and elaboration on the recommendations from the market-led Task Force on climate-related financial disclosures. The guidelines remain voluntary and are positioned as being complementary to the EU's existing rules on non-financial reporting. However, it is important not to confuse the guidelines with the separate Commission legislative initiative on a Regulation on sustainability-related disclosures in financial services sector (see Annex 1) that may lead to mandatory disclosures on sustainability risks.*

The Commission released guidelines on the disclosure of environmental and social information. These guidelines aim to help companies on a voluntary basis to disclose relevant non-financial information in a consistent and more comparable manner. They reflect current best practices and most recent developments including recommendations from the Task Force on climate-related financial disclosures set up by the Financial Stability Board. They are designed to supplement the already existing EU rules on non-financial reporting (Directive 2014/95/EU).

20 June 2019

Annex 1 – Update on EU Legislative and Regulatory Initiatives on Sustainable Finance

Legal / Regulatory Proposal	**Current Status**	**Comments**
Taxonomy Regulation	First reading by EP completed on 28.03.2019 and by the Council ongoing with latest doc on 04.04.2019.	Important changes proposed by EP: (I) life cycle and value chain assessment to be taken into account for the technical screening and the "do no significant harm" criteria; (II) (ii) disclosure of the relevant information that allow firms offering financial products to establish whether the products they offer qualify as environmentally sustainable investments pursuant to the criteria under the Taxonomy Regulation.
Amendments to Benchmark Reg. (2016/2341)	First reading by EP completed on 26.03.2019, expected to be approved by the Council without amendments as per the political agreement of 25.02.2019.	Benchmark categories/terminology in EC's proposal revised to: (i) EU Climate Transition Benchmark, which aim to lower the carbon foot print of a standard investment portfolio and which is targeting companies that follow a measurable, science-based "decarbonisation trajectory" by end-2022; (ii) EU Paris-aligned benchmarks, having more ambitious goals to select only components that contribute to attaining the 2°C reduction set out in the Paris climate agreement
Regulation on sustainability-related disclosures in financial services sector	EP's position after first reading (adopted on 18.04.2019) to be approved by the Council without amendments	EP adding definitions for "sustainability risks" (defined with reference to the materiality of the negative impact on the investment) and "sustainability factors" (defined with reference to environmental, social and employee matters, human rights, anti-corruption and bribery matters). Extended transparency requirements (i) on the potential of adverse impacts of investments decisions (Art.3gamma); and (ii) the promotion of environmental or social characteristics in pre-contractual disclosures (Art 4a).

Various Delegated Acts and Amendments to respective ESMA guidelines	EC's request on 24.07.2018 for technical advice from ESMA and EOIPA. Following the regulators' input, EC will take these delegated acts further.	PCs for amendments to various delegated under MiFID II, UCITS/AIFMD, Solvency II and Insurance Distribution Dir. PC on amendments to ESMA guidelines on product suitability and press releases as part of CRA disclosures. EIOPA and ESMA published their final reports in response to the technical advice on sustainability of the EC, on April 30th and May 3rd respectively. ESMA's final report on CRA disclosures is expected to be released by the end of July.