International
Capital
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Association

ICMA

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THE STRATEGY FOR FINANCING THE TRANSITION TO A SUSTAINABLE ECONOMY OF THE EC

ANALYSIS & COMMENTARY

On 6 July 2021, the European Commission (EC) published its Strategy for Financing the Transition to a Sustainable Economy.

The International Capital Market Association (ICMA) supports the overall ambition and key objectives of the new strategy: (1) financing the transition, (2) inclusiveness, (3) financial sector resilience and contribution to the EU Green Deal target and (4) global ambition. ICMA agrees that the capital markets can help the EU deliver on these key objectives, especially through the growth and further development of sustainable finance that the strategy aims in turn to foster.

ICMA welcomes the strategy's emphasis on transition that echoes the recommendations of the Transition Finance Report of the Commission's Platform on Sustainable Finance of which ICMA is a member. We also strongly support the priority given to adopt a delegated act under the EU Taxonomy covering the remaining four environmental goals, i.e. water, biodiversity, pollution prevention and circular economy by Q2-2022.

We are concerned however that other initiatives relating to the Taxonomy focus essentially on widening its scope as a classification tool rather than enabling it as a transition financing resource. We caution that expanding the Taxonomy to defining economic activities that "do not have a significant impact on environmental sustainability" and to those "that significantly harm environmental sustainability" are unlikely to stimulate the supply of transition finance.

We comment on the proposed EU Green Bond Standard summarising the points we have made in a separate publication. We identify a risk of duplication of market initiatives in the strategy's proposal to launch official labels for sustainability-linked or transition bonds. Conversely, we agree that a broad European sustainable label for fund products could address a gap in the market.

We otherwise comment in this paper on other initiatives in the strategy relating generally to disclosures.

Generally, we set out below key points of attention that may require further consideration in order to effectively achieve the goals envisaged by the strategy.

We also provide in the annex an infographic summary of the new actions under the EU's strategy highlighting the main areas of focus for ICMA.

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TAXONOMY

a. Expansion of the EU Taxonomy

Under its Action 1, the Commission states that it will:

- consider options to extend the Taxonomy to recognise transition efforts;
- complete the first EU Taxonomy Climate Delegated Act with regards to additional activities such as agriculture and certain energy sectors;
- complete the remaining four environmental objectives of the Taxonomy.

We strongly support these actions especially the priority given to adopt a delegated act under the EU Taxonomy covering the remaining four environmental goals, i.e. water, biodiversity, pollution prevention and circular economy by Q2-2022; and the emphasis on recognising transition efforts.

In its Overview and Recommendations for Sustainable Finance Taxonomies ICMA identifies as success criteria for taxonomy frameworks that they should (i) encourage the use of taxonomy thresholds and metrics for forward looking targeting by companies; (ii) embed in taxonomies realistic future trajectories/pathways for companies to reach the identified sustainable technical thresholds; (iii) confirm the acceptability of taxonomy grandfathering for financial products; and (iv) recognise the use of complementary approaches and metrics outside taxonomies.

We are concerned that the strategy's new actions focus essentially on widening the scope of the Taxonomy as a classification tool rather than enabling it as a transition financing resource. Defining economic activities that "do not have a significant impact on environmental sustainability and economic activities that significantly harm environmental sustainability" will make the Taxonomy analytically more comprehensive but is unlikely to increase the availability of transition finance. On the contrary, it should be clearly understood that companies engaging in activities defined as "significantly harmful" are likely to experience both increased costs and diminished access to finance as a result of this categorisation.

Furthermore, ICMA's Climate Transition Finance Handbook aims to provide guidance on how companies in those "hard to abate" sectors can develop and communicate credible transition strategies to the capital market and raise funds to finance them. The Taxonomy is identified in this context as an important potential resource. There is a notable parallel to be drawn here with the provisions contained in the draft for a Regulation for on European green bonds allowing for projects to meet the Taxonomy-criteria within a 5-year timeline in the context of a Taxonomy-alignment plan (which can be extended up to 10 years if justified and documented).

We would argue that as much priority should be given to clarifying how the Taxonomy's technical criteria can be used in a company transition plan or addressing the usability challenges of Do No Significant Harm (DNSH) or Minimum Social Safeguards (MSS) as to expanding the breadth of the Taxonomy further. This will be more useful in directly stimulating the supply of European transition finance by addressing the practical challenges of using the Taxonomy, rather than expanding its scope.

b. Social taxonomy

ICMA believes that the development of a Social Taxonomy can provide investors and issuers with a complementary tool for assessing what is 'social'. This may contribute to further develop the availability of social finance especially through the rapidly developing social bond market where the EU itself is now a key issuer. Furthermore, a Social Taxonomy, including social and governance objectives, can be important in connecting the dots with other EU regulation and thus complete the EU sustainability disclosure regime for financial and non-financial companies.

ICMA is part of the EU Platform on Sustainable Finance sub-group that is currently in the process of creating a Social Taxonomy. The group will provide advice on extending the EU Taxonomy framework to include a Social Taxonomy, considering both social and governance aspects.

c. Fostering global ambition

We support the Commission's objective to promote an ambitious consensus on sustainable finance in international forums, especially via the Commission's International Platform on Sustainable Finance (IPSF). We also welcome closer cooperation and interaction between the IPSF and the private sector. ICMA is a contributor to the G20 Sustainable Finance Working Group where the international relevance of the work of the IPSF is being taken into account.

The IPSF's upcoming report on a Common Ground Taxonomy is awaited by many jurisdictions that are looking to develop their own taxonomies. ICMA has proposed success criteria for taxonomies in a separate publication.

LABELS

a. **EU GB and other proposed bond labels**

ICMA welcomes the proposed voluntary nature for the Regulation on European green bonds ("EuGBs"), and the Commission's intention to ensure its co-existence with the existing European and international green bond market. We also note that many of the recommendations of the Technical Expert Group (TEG) to which ICMA contributed as a member have been adopted. The provision allowing for Taxonomy alignment within a 5-year period is a strong positive allowing for the use of EuGBs in transition-enabling projects.

There are however areas of concern; notably, the absence of any of the flexibility provisions recommended by the TEG for alignment with the Taxonomy where (i) the Technical Screening Criteria (TSC) may not be directly applicable because of the innovative nature, the complexity, the location, and/or other legitimate factors related to the projects or (ii) TSC have not yet been developed. We believe this may hinder, among other things, the potential for international uptake of the label. There is also only partial grandfathering for an EuGB if the Taxonomy criteria change during the life of the bond. This creates a number of significant challenges that may hinder the success of the label. ICMA's more specific and detailed view on the EuGB Regulation can be found here.

Regarding proposals for other bond products such as sustainability-linked or transition bonds, we believe there is a risk of duplication with the global market standards developed by the Green and Social Bonds Principles with the support of ICMA. Generally, we recommend that the EU should only seek to develop a sustainable bond standard where there is either (i) an overarching policy-based objective or supporting action that requires an official standard and (ii) no market-supported standard and documented evidence of market dysfunction.

Specifically, guidance for sustainability-linked bonds (SLBs) and for climate transition finance was published in 2020 by ICMA. This guidance explains that as transition projects can be financed either through green bonds or SLBs, a dedicated "transition bond" label has not been proposed. However, and as mentioned above, additional work and guidance on how the Taxonomy may be used in the context of transactions financed by SLBs (as well as green bonds) and/or for transition projects would be welcome.

b. Sustainable fund labels

Conversely, we would support a dialogue with the Commission on labels for sustainable and ESG funds (in addition to the EU Ecolabel). We believe that such a broad European label for sustainable funds can contribute to addressing the emerging risk of fragmentation in the EU, due to the proliferation of national labels and more importantly different local rules coming on top of SFDR.

DISCLOSURES & RATINGS

a. Data

We welcome the next steps announced regarding the EU taxonomy reporting, CSRD, and ESG ratings, and the European Single Access Point (ESAP) and truly hope that these initiatives can produce in a timely manner a relevant pool of ESG data that will support sustainability within the European capital markets.

Enhancing sustainability transparency and comparability is indeed crucial to allow asset owners, asset managers and other financial market participants to make informed investment decisions and meet their own regulatory obligations (such as SFDR).

b. SFDR

Regarding SFDR, we urge the EC to publish the implementation measures as soon as possible. SFDR is ambitious and has far reaching consequences across the industry; its implementation cannot be improvised. Legal clarity is needed now to be able to meet the reporting deadline.

c. CSRD and Reporting Standards

ICMA welcomed the review of the NFRD which in April resulted in the proposed CSRD. This new Directive contributes to the completion of the Capital Markets Union (CMU) and is a further step in connecting the dots with other EU Regulation that resulted from the EU Action Plan such as SFDR, the

EU Taxonomy Regulation and the amended Benchmark Regulation, all of which can only fully meet their disclosure objectives, if relevant non-financial information is available from investee companies.

ICMA supports a dialogue on the proposed mandatory EU sustainability reporting standards to be developed and drafted by the European Financial Reporting Advisory Group (EFRAG) with the aim of addressing the perceived shortcomings of the NFRD for both users and preparers relating to, among other things, a lack of comparability, reliability, and relevance of data. We note that by clarifying the obligation to report according to the double materiality perspective, the EU is proposing to cover both the "outside-in" financial materiality and "inside-out" socio-environmental perspective.

d. ESG ratings

ICMA supports a dialogue with the Commission on its plan to regulate the market for ESG ratings. While Credit Rating Agencies are already regulated by ESMA, specialised ESG rating providers are not. As a result, the methodologies for ESG ratings from specialised providers can diverge. It is important to note however that some investors consider the diversity of these methodologies as complementary and helpful.

Regulating this market through, for example, a list of key metrics focusing on environmental, social and governance criteria could however improve the reliability, comparability, and transparency of ESG ratings. Consistency with the disclosure requirements under the proposed CSRD should be carefully considered in parallel.

e. Prospectus disclosures for green, social and sustainability bonds

Action 1e of the new Sustainable Finance Strategy involves introducing "targeted prospectus disclosures for green, social and sustainable securities to enhance the comparability, transparency and harmonization of information provided for such instruments and to help fight greenwashing". This will entail proposed amendments to the EU Prospectus Regulation in 2022. When ICMA's Legal & Documentation Committee and Corporate Issuer Forum considered the question of whether specific prospectus requirements for green, social and sustainability bonds were needed in 2020, they did not consider that such specific requirements were necessary or desirable at that time and they noted that a better time to consider such requirements would be following the introduction of an appropriate regulatory regime for green, social and sustainability bond framework verification.

Nevertheless, ICMA members stand ready and willing to engage with the proposed review of the EU Prospectus Regulation regime in this area, which is also expected to include an assessment of whether it is appropriate to integrate sustainability-related information requirements into the Prospectus Regulation pursuant to Recital 7 of Regulation (EU) 2021/337 (amending the Prospectus Regulation as part of the EU's Capital Markets Recovery Package).

ANNEX – OVERVIEW OF STRATEGY FOR FINANCING THE TRANSITION TO A SUSTAINABLE ECONOMY

Main themes	Action areas most relevant to ICMA	Other action areas
Financing the transition (Action 1)	• Completion and expansion of the Taxonomy • Standards and labels (e.g. SLBs and transition themed bonds)	Potential legislation to support certain economic activities primarily in energy sector.
Inclusive framework (Action 2)	• Social taxonomy • Integrate sustainable finance related data	Access of SMEs and retails to sustainable finance; supporting social investments via SFDR measures increasing insurance coverage against env. risks; green budgeting and risk sharing.
Resilience of and contribution by financial sector (Action 3,4,5)	• ESG risks in credit ratings and outlooks and ESG research availability	Amendments to the CRR/CRD; sustainability risks in Solvency II; financial reporting standards and sustainability risks; systemic risk issues; science-based target setting, disclosure, monitoring of commitments; fiduciary duties and stewardship; supervision of greenwashing risks.
Global ambition (Action 6)	• IPSF's work, especially on taxonomies	Promoting double materiality internationally; supporting low- and middle-income countries in access to sustainable finance.