European Financial Markets Lawyers Group

Mr John C. Berrigan
Director-General of Financial Stability,
Financial Services and Capital Markets Union

Mr. Martin Spolc
Head of Sustainable Finance
Directorate-General for Financial Stability,
Financial Services and Capital Markets Union

European Commission
1049 Bruxelles
Belgium

via email:
john.berrigan@ec.europa.eu
Martin.SPOLC@ec.europa.eu

30 June 2021

Dear Mr Berrigan, Dear Mr Spolc,

**EFMLG suggestions regarding the EU Taxonomy Article 8 disclosures delegated act**

As you know, the European Financial Markets Lawyers Group (the "EFMLG") is a group of senior legal experts from the EU banking sector dedicated to making analysis and undertaking initiatives intended to foster the harmonisation of laws and market practices and facilitate the integration of financial markets in Europe. The members of the EFMLG are selected on the basis of their personal experience amongst lawyers of major EU-based credit institutions. The EFMLG is hosted by the European Central Bank.

The EFMLG fully supports the European Commission's action plan on sustainable finance in order to facilitate investments in sustainable projects and assets across the EU. Since May 2018, the Commission has put forward numerous legislative and regulatory texts including measures to help direct capital towards sustainable initiatives and to contribute to the EU's goals to reduce its greenhouse gas emissions by at least 55% by 2030 and reach its 2050 carbon neutrality goal. The long-term vision of a climate neutral society is at the heart of the European Green Deal and it is widely recognized that the EU strategy may have the potential to generate unprecedented opportunities for the EU.

In this vein, the EFMLG welcomes (i) the Commission's recent sustainable finance package[1] which focuses among other things on significant sustainability reporting and disclosure obligations as well as (ii) the draft EU Taxonomy Article 8 Delegated Act released on 7[h] May 2021 (below the "draft Delegated Act").

1 On 21[st] April 2021, the EU Commission adopted package of measures as part of its policy in sustainable finance: https://ec.europa.eu/info/publications/210421-sustainable-finance-communication_en;

Given the significant reach of the draft Delegated Act and whilst we are aware that we are not meeting the 2 June deadline for feedback set by the Commission , we would like nevertheless to provide the Commission with a few comments in the hope that they might also help to shape a robust piece of ESG reporting in the EU.

Therefore, the EFMLG has prepared the below list of points for the consideration of the Commission. The EFMLG is aware of other initiatives which also make suggestions towards the deepening or the completion of the EU sustainability reporting mechanism. Certainly, some of the EFMLG points below may coincide with points made in any such other initiatives.

Our main observations are detailed below but, in brief, the priority in relation to the banks' green asset ratio ("GAR") is in our view to (i) make sense for investors, (ii) allow for comparability between banks and between different time periods, and (iii) rely on comprehensive and comparable data from non-financial undertakings.

From this perspective, **we strongly recommend a close articulation between the reporting obligations under the draft Delegated Act and the NFRD and the forthcoming CSRD as well as a consistent approach between the numerator and the denominator of the taxonomy-alignment ratios**. We also recommend **further consideration on derivatives in the context of the review clause**.

**<u>The phase-in approach is to be further extended for the sake of better ESG data reporting</u>**

The phase-in approach proposed by the Commission, whereby credit institutions shall disclose only information on exposures to activities listed in the Taxonomy, the so called "eligible activities" in Q1 2022 and Taxonomy aligned activities based on "real data" coming from NFRD companies in Q1 2023, is welcomed. However, as prompted by the requirements under Article 11 of the draft Delegated Act, the use of proxies to address the unavailability of certain data for reporting obligations to be applied from 1st January 2023, may undermine the transparency and reliability objectives of the reporting exercise. A ratio mainly based on proxies would have no or little significance for ESG reporting and steering capacities. It would also prevent comparability amongst banks. To address this pitfall, the date of the first reporting should be postponed by one accounting year for financial institutions compared to the first reporting of their counterparties (both non-financial counterparts and other financial counterparts). This would imply that financial institutions would report eligible activities in 2022 and 2023 and start reporting aligned activities from January 2024 for their non-financial counterparts and from 2025 for their financial counterparts.

**<u>The disclosure requirements remain highly complex and potentially non ESG sensitive</u>**

**A. Ensure consistency with non-financial undertakings' reporting**

We welcome the Commission's proposal to bring more consistency between Article 8 of the Taxonomy Regulation, NFRD and the forthcoming CSRD than initially reflected into the EBA technical advice.

It is critical to phase-in the application of financial institutions' disclosures of Taxonomy-related information on companies not (yet) under the obligation to provide mirroring information.

The obligation should be phased-in as follows:

- until 2025 with regards to taxonomy-related information on the exposures to large non-financial undertakings not yet under the NFRD and were they ultimately subject to the CSRD;
- until 2028 with regard to the exposures to listed SMEs should they ultimately be subject to the CSRD.

Even after those dates, it would though be unrealistic to keep in scope entities that are outside of the CSRD scope. As it is already knowingly challenging for very large EU listed companies to compute the three KPIs on turn-over derived from, CAPEX and OPEX directed to sustainable activities or eligible activities, it is in our view unlikely that financial institutions will be able to collect any data from smaller entities or non-EU entities excluded from the CSRD on a voluntary basis.

As for the complexity of the reporting obligation for non-financial undertakings we would suggest the following simplifications without reducing the quality of information that EU banks need to compute their own Taxonomy alignment reporting:

- Replace the mandatory disclosure of CapEx and OpEx KPIs by a voluntary disclosure of such metrics or a description of transition pathways, as put forward by the EU Platform on Sustainable Finance, including when relevant details of investments planned.
- Streamline the presentation of the KPIs by focusing on the proportion of revenue associated with Taxonomy-aligned activities.
- Only indicate the share of revenue coming from Taxonomy-eligible activities without the details on DNSH for these activities.

**B. Solve inconsistencies between the numerator and the denominator of Taxonomy-alignment metrics**

Consistency between the numerator and the denominator of banks' Taxonomy-alignment metrics is critical in order to ensure that the ratios can be compared from one entity to the other, and between different time periods for the same entity. Activities that are excluded from the numerator (i.e. exposures to non-EU activities, to SMEs and general consumers loans, trading book and derivative exposures), on the basis that their sustainability assessment is not possible at this stage, should also be excluded from the denominator.

As stated by the EBA, including them in the denominator but not in the numerator would de facto imply that they are included in the numerator with a 0% weight. This is assuming that no part of such activities is associated with activities that qualify as environmentally sustainable, which would be inaccurate, as in reality there is no methodology or public information that allows assessment of their sustainability.

The inconsistency between the numerator and the denominator will not only be misleading but also undermine the level playing field between banks based on the nature of their business model. Banks financing activities outside of the EU, those primarily focusing on SMEs financing or those bringing hedging solutions to industries or market liquidity will report the lowest ratios.

We are concerned over the consequences of such approach in a context where:

- Institutional investors plan to integrate climate dimension in their investment decisions. Therefore, that might also raise the question of the attractiveness of the EU banking sector for investors.
- Interbank loans will be fully subject to green ratios reporting. This means that banks will consider the green ratios of other banks where they provide them with loans. Would that mean that banks which fund SMEs to a great extent would have less access to refinancing market?

Some institutions may be encouraged to improve their KPIs by purely reducing the denominator, moving their financing away from those activities. In particular, this raises the question of the EU banks' ability to finance the transition and development of emerging economies such as in Africa, which is also part of the EU goals.

Hence, an alternative approach could be proposed whereby the scope of the green asset ratio (including its denominator) will be **aligned with the scope of the NFRD, and, from 2025, of the CSRD, in accordance with the phase-in approach provided otherwise by the Commission.**

**If the Commission's intention is to require banks to offer more transparency on their whole balance sheet, we would recommend exploring alternative disclosure requirements including:**

1. Value of total assets
2. Value of assets not covered by the GAR:
    - SMEs and NFCs (other than SMEs) not subject to NFRD disclosure obligations
    - Total value of exposures to non-EU counterparties
    - Derivatives
    - Trading book
    - On-demand interbank loans
    - Exposures to sovereigns and central banks.

**C. Ensure the role of derivatives is recognized in taxonomy-alignment metrics**

In a modern economy, derivatives are indispensable instruments for the development of an industry:

- they make it possible for corporate companies to hedge their risks, both on their industrial activities (on the price of commodities for instance) and on their financial structure (forex, rates), and hence foster their development,
- they make it possible for investors and banks to limit and redistribute their risks (stemming from investments in equities, purchase of bond or granting of loans) across the financial

community, through equity[2], rates or credit instruments, and hence facilitate the financing of the considered industry at reasonable costs.

The exclusion of derivatives from the numerator of taxonomy-alignment ratios reveals that their role is not duly recognized. More importantly, were it to be confirmed, it would hamper the development of green companies / activities and the transition of existing companies / activities, and hence go against the very objective to reach carbon neutrality by 2050.

With this in mind, we would recommend extending the review clause to derivatives in order to show that derivatives can be considered for their contribution to green finance/investments.

In the meantime, as mentioned above, it would be essential to ensure consistency between the ratios' numerator and denominator.

Yours faithfully,

Otto Heinz, Chairman to the EFMLG

[2] Like packaged products for instance, be it funds, structured deposits, insurance products or structured products. It should be observed that it is not possible to incorporate capital-protection in those products, without embedding derivatives.