ISDA-AFME feedback on the draft technical advice on minimum requirements for the EU climate-transition benchmarks and the EU Paris-aligned benchmarks and benchmarks' ESG disclosures

2 August 2019

Introduction

The International Swaps and Derivatives Association ("ISDA") and the Association for Financial Markets in Europe ("AFME") welcome the opportunity to comment on the interim report on Climate Benchmarks and Benchmarks' ESG disclosures by the EU Technical Expert Group (TEG) on Sustainable Finance.

1. **Proportionality in the European Benchmarks Regulation shall apply in relation to ESG disclosure for non-ESG benchmarks**

The benchmarks market is characterized by a high quantity and diversity of benchmarks, ranging from highly referenced benchmarks (critical and significant benchmarks) such as EURIBOR and Euro Stoxx 50 to small, highly customized benchmarks, which reflect an individual investor's investment strategy (included in the non-significant category). The European Benchmarks Regulation (BMR) reflects the variety of benchmarks by distinguishing between types of benchmarks (interest-rate-, regulated-data-, and commodity- benchmarks) and size of benchmarks (critical, significant, and non-significant benchmarks). The BMR sets higher requirements for critical and significant than for non-significant benchmarks. ISDA and AFME would welcome that the requirements for non-significant benchmarks in relation to Environmental, Social and Governance (ESG) criteria and carbon emissions disclosure should follow a consistent proportionality approach, i.e. ESG disclosure requirements for significant benchmarks shall be more comprehensive than for non-significant benchmarks.[1] We would welcome the TEG final report to reflect this proportionality as disclosure of ESG factors and Key Performance Indicator (KPIs) should be in the form of guidelines rather than mandatory for non-significant benchmarks.

With regard to non-ESG, non-significant benchmarks, investors will continue to have legitimate preferences driven by financial stability, risk management or investment safety considerations that may be prevailing over sustainability objectives. When faced with concrete constraints, they will still need highly adapted or customized benchmarks to reference financial instruments, contracts or funds and it is not always possible to disclose for these benchmarks a long list of available, useable and auditable ESG data on the underlying assets. Creating benchmarks for which ESG data is available, useable and auditable should not be done to the detriment of matching the end investor preferences and principal investment priorities that should remain the priority objective. Also, ESG disclosures (particularly where data sources are limited or verification of the data is required) could translate into additional costs which (a) could make the proposed investment strategy more costly when compared to equivalents in

[1] The category of critical benchmarks consists of highly-referenced interest rate benchmarks which are not subject to the requirements of the 'EU Climate Transition and EU Paris-aligned benchmarks' regulation.

other non-EU markets and (b) the investors may not be ready to support if they have not expressed any particular preference for ESG objectives.

Furthermore, it is to be noted that this requirement may conflict with the practical reality of the benchmark administration process. The majority of non-significant benchmarks are dynamic (there is regular rebalancing of the underlying assets to meet the benchmark methodology on a continuous basis and be consistent with the investor's initial request). It may therefore become incredibly complex to receive and disclose ESG data on a dynamic basis as soon as there is a rebalancing.

We also note that the Regulation amending Regulation (EU) 2016/1011 states that for benchmarks or families of benchmarks which do not pursue ESG objectives, *"it shall be sufficient for benchmark administrators to clearly state in the benchmark statement that they do not pursue such objectives"*. The Regulation does not provide that this should only be a last resort option. While there may be some non-ESG benchmarks for which it is possible to give these disclosures (the TEG report gives the single example of the Blackrock iShares ETFs, which are in the unusual position that the necessary information would generally be available for most of their underlying assets), for the vast majority of non-ESG benchmarks this information is not currently available, usable or auditable.

As a result, we would strongly recommend that the Commission's delegated act aligns with the Level 1 provision that it is sufficient for administrators of non-ESG benchmarks to disclose in their benchmark statement that the benchmark does not pursue ESG objectives, rather than seeking to limit this to a last resort option.

If the Commission does intend to provide that this should be a last resort option only, we would suggest that ESG disclosure obligations for non-ESG benchmarks are conditional upon 1) the availability, usability and auditability of ESG data on all the underlying assets; and 2) to clients' agreement to receive ESG data on the underlying assets with any potential consequences for the strategy's pricing. If those cumulative conditions are not fulfilled, it should be acceptable for those benchmarks to only specify in their statement that they do not pursue ESG objectives.

2. Differentiation by asset class, type of benchmarks, investors' need is necessary for effective ESG disclosures

The agreement between the European Parliament and the Council of the EU on the EU Climate Transition and EU Paris-aligned benchmarks file introduces requirements for all benchmark administrators, to disclose in their methodology document *'an explanation of how the key elements of the methodology… reflect environmental, social or governance ('ESG') factors for each benchmark or family of benchmarks …'*. In addition, a benchmark statement shall contain *'an explanation on how ESG factors are reflected in each benchmark…For those benchmarks… not pursuing ESG objectives, it shall be sufficient for benchmark administrators to clearly state in the benchmark statement that they do not pursue ESG objectives.'*

Given the characteristics and diversity of benchmarks, we welcome the TEG's approach to adapt disclosure requirements to different asset classes. In particular, we welcome that derivative instruments for the transfer of credit risk, such as CDS, should not apply ESG disclosure, agreeing with the TEG's analysis that setting any ESG disclosure for a CDS index would essentially require disclosing the characteristics of a second level structured product. Consistent with this approach (and in line with the text of the Regulation amending Regulation EU 2016/1011), we support an exemption of ESG disclosures for all derivatives benchmarks that do not specifically pursue ESG objectives. For this type of benchmarks, such as equity or commodity derivative benchmarks, ESG disclosures would not add any valuable information for the end investor given that derivatives are based on the value of other assets. This argument is also consistent with the JRC technical report[2] on the development of EU ecolabel criteria: *"In terms of the scope of assets that could be verified within a portfolio, financial derivatives were considered in the PR to this study and by the stakeholders to be technically complicated to be addressed within the framework of the EU Ecolabel, especially in the context of their verification. This is because their return is based on the value of other assets. So whilst an EU Ecolabelled financial product might necessarily still include derivatives within the portfolio it may not be necessary to verify their greenness"*.

With regard to ESG benchmarks, the TEG report states that investors *'have a different appetite'* in relation to excluding issuers and economic activities from their investment portfolio based on their carbon emissions. ISDA and AFME agree with this analysis, which should also apply to ESG disclosures in light of the different prioritisation made by investors in respect of the list of ESG factors depending on their values. Therefore, ISDA and AFME would like to call on the European Commission to consider the different types of investment styles when preparing the delegated act on minimum requirements for ESG disclosure.

3. Availability of high quality and affordable data needs to be enhanced

ISDA and AFME also have concerns whether high quality data is easily available, usable and auditable. Although the quality of ESG data continues to improve, we think that there are still considerable challenges with the consistency of ESG data. Individual ESG metrics vary and, as such, ESG scoring also varies between different data providers. The variety of required ESG data may be difficult to obtain as benchmark administrators, in particular administrators of non-significant benchmarks, would heavily rely on third party providers. As the TEG interim report states, the dependencies on third party providers *'might have an impact on pricing schedules offered by third party data providers'*. Because data related costs have significantly increased in recent years, the disclosure of ESG information for all benchmark administrators may either be impossible, or the associated administrative burden would be very significant. Therefore, we support the TEG's recommendation for a non-disclosure option in the template for the methodology and the benchmark statement. This is also in line with the primary legislation (level 1 text of the EU Benchmarks Regulation).

Benchmark administrators who pursue ESG objectives, including the requirements for EU climate transition benchmarks (being on a decarbonisation trajectory) and Paris-aligned benchmarks (contributing to achieving the 2°C reduction of global temperatures), shall not be prevented from obtaining one of the two EU designated labels for failing to acquire the relevant

[2] https://susproc.jrc.ec.europa.eu/Financial_products/docs/20190315%20TR%201.0%20EU%20EL%20Financial%20Products_Final%20consultation.pdf

ESG data, if such data is not available, usable and auditable. This could provide significant remedies to entities already engaging in the ESG benchmarks market:

- *Administrators*: Administrators may fail to report on all relevant ESG factors, and would thus be unable to obtain the official EU designation amid fulfilling the carbon objective of the legislation and the 'do not significantly harm' principle in relation to other ESG factors.
- *Users*: A rigid methodology reduces the ability of benchmark administrators to provide benchmarks that meet diverging investment needs, thus reducing the overall market uptake of the EU designated carbon benchmarks by users. The proposed constraints can also be counterproductive when applied at national level given the smaller universe. The resulting increased concentrations may create unintended risks for investors, and it may not be possible for investors to maintain cross sectional diversification.

In total, if ESG data disclosure requirements are too rigid, the required growth of the ESG market, needed to fulfil the overarching objective of the sustainable finance agenda may be jeopardized. In order to facilitate the availability of data, the co-legislators and the European Commission, depending on the type of legislation, shall align disclosure requirements resulting from other financial services legislations with the requirements of the BMR.

As the TEG report points out in Chapter 3.7 'Areas for further work', the requirements in the amended BMR in relation to ESG and carbon emission disclosure shall be aligned with the 'Regulation on sustainability-related disclosures in the financial services sector' and the 'Non-Financial reporting Directive' as it covers reporting requirements of for non-financial and financial issuers of underlying assets. Therefore, the European Securities and Markets Authority (ESMA) and the European Commission shall engage in providing guidance regarding reporting requirements across different regulations and facilitate the availability of reliable and affordable ESG data. We also note that the European Commission has issued 'guidelines' for issuers regarding climate related disclosures in June 2019 accompanying the Non-Financial Reporting Directive. These guidelines are non-binding, aimed at aligning with the Task Force on Climate-related Financial Disclosures (TCFD) and consider materiality of the information disclosed. As a result, it would not be practical or appropriate to impose mandatory ESG disclosure requirements on benchmark administrators, which are broader and more detailed than the existing guidelines for issuers. For example, with such disclosure requirements, an equity benchmark administrator would not be able to provide appropriate disclosure of ESG information based on the information obtained about the issuer of the underlying asset.

Given the challenges of obtaining all required ESG data, we would also recommend that the proposed templates for ESG factors shall be updated on a yearly rather than a quarterly basis. In addition, this would also be aligned with the annual reporting by issuers. We would also like to caution against the implementation date of 30 April 2020, given that the technical standards are only expected to be finalised shortly before this deadline.

Disclosure of carbon related information

Similar to the ESG disclosures, the European Commission shall take into account the stage of development in relation to the disclosure of climate related information. As the TEG report acknowledges, *'the current state of methodologies and available issuer-level data does not allow for an evident and irrefutable conversion of climate scenarios into detailed and informed portfolio construction methodologies…'*.

Therefore, the report recommends to only include corporate issuance-based indices in the scope of the climate related disclosure obligations.

ISDA and AFME agree with the TEG's assessment that scope 3 emissions should be phased in given that data availability for scope 3 emissions is lacking. Furthermore, scope 3 emissions may not be appropriate to compare companies' carbon performance as it is a tool to analyse carbon emissions throughout the supply chain, i.e. the scope 3 values depend on company structure and do not reflect the actual carbon emissions. Therefore, scope 3 emissions could highly mislead investors. As the Greenhouse Gas Protocol notes in its October 2011 FAQ[3] *"[scope 3 emissions enable comparison of a company's GHG emissions over time. It is not designated to support comparisons between companies based on their scope 3 emissions"*.

ISDA and AFME also support the exemption in relation to benchmark administrators using an external GHG data provider in relation to the disclosure of the GHG emissions estimations, as it would otherwise further increase the administrative burden without offering any added value in requiring the data provider and the administrator to engage in a similar methodological exercise.

Lastly, ISDA and AFME agree with the TEG report's analysis that an exclusion of sectors and issuers would be counterproductive to the transition element to a low-carbon economy. In order to fulfil the climate ambition manifested in the Paris agreement, it is necessary for companies or sectors to further decarbonize their economic activities and practices. Given the forward-looking approach in developing a European sustainable finance framework, any such exclusion based on past data would contradict the objective of the approach.

For more information please contact Kai Möritz (KMoritz@isda.org), Stevi Iosif (SIosif@isda.org) and Tonia Plakhotniuk (Tonia.Plakhotniuk@afme.eu).

[3] https://ghgprotocol.org/sites/default/files/standards_supporting/FAQ.pdf

About ISDA: Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 900 member institutions from 71 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter @ISDA.

About AFME
AFME (Association for Financial Markets in Europe) advocates for deep and integrated European capital markets which serve the needs of companies and investors, supporting economic growth and benefiting society. AFME is the voice of all Europe's wholesale financial markets, providing expertise across a broad range of regulatory and capital markets issues. AFME aims to act as a bridge between market participants and policy makers across Europe, drawing on its strong and long-standing relationships, its technical knowledge and fact-based work. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in 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) through the GFMA (Global Financial Markets Association). For more information please visit the AFME website: www.afme.eu.