JOINT COMMITTEE OF THE EUROPEAN SUPERVISORY AUTHORITIES

Response form for the Joint Consultation Paper concerning Taxonomy-related sustainability disclosures

Date: 17 March 2021
ESMA34-45-1218

European Securities and Markets Authority | EUROPEAN BANKING AUTHORITY | EUROPEAN INSURANCE AND OCCUPATIONAL PENSIONS AUTHORITY | JOINT COMMITTEE OF THE EUROPEAN SUPERVISORY AUTHORITIES

Responding to this paper

The European Supervisory Authorities (ESAs) welcome comments on this consultation paper setting out the proposed Regulatory Technical Standards (hereinafter "RTS") on content and presentation of disclosures pursuant to Article 8(4), 9(6) and 11(5) of Regulation (EU) 2019/2088 (hereinafter Sustainable Finance Disclosure Regulation "SFDR") and in particular on the specific questions summarised in Section 3 of the consultation paper under "Questions to stakeholders".

Comments are most helpful if they:

- contain a clear rationale; and
- describe any alternatives the ESAs should consider.

When describing alternative approaches the ESAs encourage stakeholders to consider how the approach would achieve the aims of SFDR.

Instructions

In order to facilitate analysis of responses to the Consultation Paper, respondents are requested to follow the below steps when preparing and submitting their response:

- Insert your responses to the questions in the Consultation Paper in the present response form.

- Please do not remove tags of the type <ESA_QUESTION_ESG_1>. Your response to each question has to be framed by the two tags corresponding to the question.

- If you do not wish to respond to a given question, please do not delete it but simply leave the text "TYPE YOUR TEXT HERE" between the tags.

- When you have drafted your response, name your response form according to the following convention: ESA_ESG_nameofrespondent_RESPONSEFORM. For example, for a respondent named ABCD, the response form would be entitled ESA_ESG_ABCD_RESPONSEFORM.

- The consultation paper is available on the websites of the three ESAs and the Joint Committee. Comments on this consultation paper can be sent using the response form, via the ESMA website under the heading 'Your input - Consultations' by 12 May 2021.

- Contributions not provided in the template for comments, or after the deadline will not be processed.

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise in the respective field in the template for comments. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESAs rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESAs Board of Appeal and the European Ombudsman.

Data protection

The protection of individuals with regard to the processing of personal data by the ESAs is based on Regulation (EU) 2018/1725[1]. Further information on data protection can be found under the Legal notice section of the EBA website and under the Legal notice section of the EIOPA website and under the Legal notice section of the ESMA website.

[1] Regulation (EU) 2018/1725 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 23 October 2018 on the protection of natural persons with regard to the processing of personal data by the Union institutions, bodies, offices and agencies and on the free movement of such data, and repealing Regulation (EC) No 45/2001 and Decision No 1247/2002/EC, OJ L 295, 21.11.2018, p. 39.

General information about respondent

Name of the company / organisation	Click here to enter text.
Activity	Choose an item.
Are you representing an association?	☒
Country/Region	Choose an item.

Introduction

Please make your introductory comments below, if any:

<ESA_COMMENT_ESG_1>
ISDA welcomes the opportunity to comment on the draft regulatory technical standards set out in the ESAs' Joint Consultation Paper concerning Taxonomy-related sustainability disclosures.

The transition to a sustainable economy will take a significant amount of long-term funding. Derivatives perform a critical role in economic activity by facilitating the raising and allocation of capital for green finance, enabling, and helping businesses and investors better manage the risks to which they are exposed, and to more effectively align their exposures with risk tolerance and risk management requirements. The derivatives market also plays a major role in enhancing transparency through providing information on the underlying commodities, securities or assets, which can ultimately contribute to long-term sustainability objectives.[2]

The financial sector is responding to the challenges in sustainable finance with a diverse range of product structures and transaction types in the derivatives market. While conventional derivatives can certainly be used to hedge green instruments, a new wave of sustainability-linked derivatives and exchange-traded ESG derivatives has also developed in recent years, alongside emissions trading derivatives, renewable energy and renewable fuels derivatives, and catastrophe and weather derivatives.[3]

In response to Question 4, ISDA is of the view that derivatives should be included in the proposed KPI for the disclosure of the extent to which investments are aligned with the taxonomy but only where they are used to attain the environmental or social characteristics promoted by the financial product or the sustainable investment objective of the financial product. Additionally, ISDA believes that it would be particularly helpful if this approach were to be applied consistently across all relevant calculation KPIs in respect of NFRD entity reporting under Article 8 of the Taxonomy Regulation as differing interpretations could create investor confusion and result in fragmented outcomes.

ABOUT ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 925 member institutions from 75 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, LinkedIn, Facebook and YouTube.

[2] The role of derivatives in sustainable finance is explored in greater detail in a July 2020 paper published by the Centre for European Policy Studies ("CEPS") and the European Capital Markets Institute ("ECMI"), https://www.isda.org/a/KOmTE/Derivatives-in-Sustainable-Finance.pdf

[3] ISDA paper on Overview of ESG-related Derivatives Products and Transactions, https://www.isda.org/a/qRpTE/Overview-ofESG-related-Derivatives-Products-and-Transactions.pdf.

<ESA_COMMENT_ESG_1>

Q1 : Do you have any views regarding the ESAs' proposed approach to amend the existing SFDR RTS instead of drafting a new set of draft RTS?

<ESA_QUESTION_ESG_1>
TYPE YOUR TEXT HERE
<ESA_QUESTION_ESG_1>

Q2 : Do you have any views on the KPI for the disclosure of the extent to which investments are aligned with the taxonomy, which is based on the share of the taxonomy-aligned turnover, capital expenditure or operational expenditure of all underlying non-financial investee companies? Do you agree with that the same approach should apply to all investments made by a given financial product?

<ESA_QUESTION_ESG_2>
TYPE YOUR TEXT HERE
<ESA_QUESTION_ESG_2>

Q3 : Do you have any views on the benefits and drawbacks of including specifically operational expenditure of underlying non-financial investee companies as one of the possible ways to calculate the KPI referred to in question 2?

<ESA_QUESTION_ESG_3>
TYPE YOUR TEXT HERE
<ESA_QUESTION_ESG_3>

Q4 : The proposed KPI includes equity and debt instruments issued by financial and non-financial undertakings and real estate assets, do you agree that this could also be extended to derivatives such as contracts for differences?

<ESA_QUESTION_ESG_4>
Derivatives perform a critical role in economic activity by facilitating the raising and allocation of capital for green finance, enabling, and helping businesses and investors better manage the risks to which they are exposed, and to more effectively align their exposures with risk tolerance and risk management requirements. The derivatives market also plays a major role in enhancing transparency through providing information on the underlying commodities, securities or assets, which can ultimately contribute to long-term sustainability objectives.

The financial sector is responding to the challenges in sustainable finance with a diverse range of product structures and transaction types in the derivatives market. While conventional derivatives can certainly be used to hedge non- ESG related risks associated with green instruments, including credit, FX and interest rate risks, a new wave of sustainability-linked derivatives and exchange-traded ESG derivatives has also developed in recent years, alongside existing derivatives such as emissions trading derivatives, renewable energy and renewable fuels derivatives, and catastrophe and weather derivatives.

In line with ISDA's previous response to the ESA's Joint Consultation Paper on ESG disclosures, we are of the view that the proposed KPI for the disclosure of the extent to which investments are aligned with the taxonomy should include derivatives but only to the extent they meet each of the environmental and social characteristics or sustainable investment objectives promoted by the financial product. Additionally, we think that it would be helpul if our suggested approach were to be applied consistently across all relevant calculation KPIs in respect of NFRD entity reporting under Article 8 of the Taxonomy Regulation as differing interpretations could create investor confusion, result in fragmented outcomes and minimise the potential for evolution of risk management practices in the ESG space going forward.

For example, derivatives may be used in an ESG fund to hedge against currency and interest rate risks, with the derivatives themselves not having a sustainable investment objective.These types of derivatives should not be categorised as “sustainable investments” as they would not meet the environmental and sustainable characteristics of a financial product.

Extending the KPI to include all types of derivatives would be inherently disproportionate for investors and lead to misleading results. If this distinction is not clearly made, there is a risk that some financial market participants may include all types of derivatives for the purpose of the KPI calculations, or cherry pick the circumstances in which they include derivatives (e.g., only including them when they contribute positively to the proportion of sustainable investments and excluding them when they would dilute this proportion). This would make these disclosures significantly less useful to investors and would reduce the extent to which it is possible to make comparisons between similar products.

Assuming that the purpose of the sustainable finance disclosures is to show the overall asset allocation of a fund and how that asset allocation attains the relevant ESG characteristics / objectives, then financial market participants should at least be able to clarify in a statement that the use of plain vanilla derivatives (e.g. currency or interest rate derivatives) is not connected to the ESG characteristics of the financial product, where this is the case, and explain its purpose within the fund's investments, with a view to excluding these types of derivatives from the KPI calculations of sustainable investments proportions.

Additionally, ISDA would like to comment on the ESAs’ statement contained in the draft RTS under the SFDR that *“the disclosure of derivatives should be limited to where they are used for speculative purposes to achieve the sustainability characteristic or objective of the financial product.”* We believe that the use of the term ‘speculative’ is creating confusion as it could be interpreted to suggest that derivatives can be categorised as either "speculative" or "hedging" that would not appropriately reflect the various uses of derivatives.

Given the specific use of the term "speculative" in other contexts (e.g., under EMIR) in contrast to "hedging", it is very unclear when exactly a derivative would be considered to be "hedging" rather than "speculative". If the ESAs intent in this instance is to interpret "hedging" by reference to definitions in other legislation, it would not seem appropriate to align the definition of "hedging" for these purposes with the accounting definition of "hedging", as we understand that the point of the ESAs guidance is to try to clarify when a derivative is used to "attain a characteristic or objective". Therefore, what we extrapolate from this statement is that derivatives that are entered into for purposes unconnected with the sustainable characteristic or objective of the relevant product should be excluded from the relevant sustainable calculations. We would, however, very much welcome a clarification from the ESAs on this point.

Finally, as highlighted in the Centre for European Policy Studies (CEPS) paper on the role of derivatives in sustainable finance, it is important to note that derivatives are a tool that can support both long-term and shorter-term investment strategies, rather than an indicator of the type of strategy undertaken. However, the misuse of derivatives by market participants – like the misuse of any financial instrument – could give rise to short-termism. Opting for most liquid positions to gain exposure to one market segment, even when there is no underlying risk to hedge, does not prove an intent to trade short-term. Derivatives may have to be rolled or renewed but the exposure may be maintained over a long-term period. Moreover, all financial instruments carry the risk of loss. Thus, as long as derivatives are not misused, to artificially influence pricing of the underlying asset, they cannot fuel short-termism.[4]
<ESA_QUESTION_ESG_4>

Q5 : Is the use of “equities” and “debt instruments” sufficiently clear to capture relevant instruments issued by investee companies? If not, how could that be clarified? Are any specific valuation criteria necessary to ensure that the disclosures are comparable?

[4] https://www.ceps.eu/download/publication/?id=29791&pdf=Derivatives-in-Sustainable-Finance.pdf

<ESA_QUESTION_ESG_5>
TYPE YOUR TEXT HERE
<ESA_QUESTION_ESG_5>

Q6 : Do you have any views about including all investments, including sovereign bonds and other assets that cannot be assessed for taxonomy-alignment, of the financial product in the denominator for the KPI?

<ESA_QUESTION_ESG_6>
TYPE YOUR TEXT HERE
<ESA_QUESTION_ESG_6>

Q7 : Do you have any views on the statement of taxonomy compliance of the activities the financial product invests in and whether those statements should be subject to assessment by external or third parties?

<ESA_QUESTION_ESG_7>
TYPE YOUR TEXT HERE
<ESA_QUESTION_ESG_7>

Q8 : Do you have any views on the proposed periodic disclosures which mirror the proposals for pre-contractual amendments?

<ESA_QUESTION_ESG_8>
TYPE YOUR TEXT HERE
<ESA_QUESTION_ESG_8>

Q9 : Do you have any views on the amended pre-contractual and periodic templates?

<ESA_QUESTION_ESG_9>
TYPE YOUR TEXT HERE
<ESA_QUESTION_ESG_9>

Q10 : The draft RTS propose unified pre-contractual and periodic templates applicable to all Article 8 and 9 SFDR products (including Article 5 and 6 TR products which are a sub-set of Article 8 and 9 SFDR products). Do you believe it would be preferable to have separate pre-contractual and periodic templates for Article 5-6 TR products, instead of using the same template for all Article 8-9 SFDR products?

<ESA_QUESTION_ESG_10>
TYPE YOUR TEXT HERE
<ESA_QUESTION_ESG_10>

Q11 : The draft RTS propose in the amended templates to identify whether products making sustainable investments do so according to the EU taxonomy. While this is done to clearly indicate whether Article 5 and 6 TR products (that make sustainable investments with environmental objectives) use the taxonomy, arguably this would have the effect of requiring Article 8 and 9 SFDR products making sustainable investments with social objectives to indicate that too. Do you agree with this proposal?

<ESA_QUESTION_ESG_11>
TYPE YOUR TEXT HERE
<ESA_QUESTION_ESG_11>

Q12 : Do you have any views regarding the preliminary impact assessments? Can you provide more granular examples of costs associated with the policy options?

<ESA_QUESTION_ESG_12>
TYPE YOUR TEXT HERE
<ESA_QUESTION_ESG_12>