16 September 2019

Mr. Olivier Guersent
Director General
DG for Financial Stability, Financial Services and Capital Markets Union
European Commission

Re: EU Sustainable Finance Taxonomy

Dear Mr. Guersent,

The Institute of International Finance (IIF) and its members, which broadly represent the global financial services industry ("industry"), appreciate the opportunity to provide high-level comments on the European Commission's Technical Expert Group (TEG) report on an EU Taxonomy for sustainable finance. This is a supplement to the letter we provided in March setting out principles on the need for a taxonomy that is practical, adaptable and internationally applicable. The IIF is a global association, with close to 450 members from 70 countries, including commercial and investment banks, asset managers, and insurance companies globally. The comments in this letter have been informed by discussions of the IIF Sustainable Finance Working Group (SFWG), chaired by Daniel Klier (Group Head of Strategy and Global Head of Sustainable Finance, HSBC). The SFWG is honored to be a stakeholder of the Central Banks and Supervisors Network for Greening the Financial System.

The IIF strongly supports a just transition to a low-carbon economy, with due consideration given to a broad range of stakeholders. Public policy has an essential role in creating an appropriate framework to mobilize both public and private sources of sustainable finance, and we very much welcome the focus the EU has placed on bringing forward proposals in this area. The IIF SFWG continues to favour a flexible and principles-based approach to the development of any taxonomy—particularly to ensure continued support for market-based mechanisms that have already established themselves (e.g. ICMA's Green/Sustainability/Social Bond Principles, LMA's Green Loan Principles, etc.). Such an approach would reduce the level of complexity and data dependence that investors will face and the risks of unintended consequences. For instance, the criteria that set thresholds for companies' reductions in greenhouse gas emissions are not sensitive to different starting points, suggesting that a company with high greenhouse gas emissions will reduce its relative emissions more easily than a company with already-low emissions. Nevertheless, the SFWG recognizes the tremendous technical expertise that has gone into the TEG's more granular, activity-based EU Taxonomy and appreciates the science-based way in which it was developed. We have also appreciated the regular briefings received from our members who have participated in the work of the TEG. Thus, the SFWG offers the following comments in the spirit of making the EU Taxonomy function as efficiently as possible, and to help smooth its introduction into the market.

1. **Using existing standards and aligning regulatory schemes**
   The TEG report provides an impressive summary of the latest scientific thinking on what kinds of activities can make a substantial contribution to climate change mitigation while not doing harm to other key environmental objectives and respecting social safeguards. The largely technology-neutral approach taken is sensible, with its mix of intensity-based thresholds (e.g. 100g$CO_2$e/kWh for electricity generation), relative measurements against established company baselines (e.g. in agriculture production), and reference to existing market standards and labels (e.g. energy performance certifications for buildings). However, the SFWG believes that the more existing market standards and labels used widely by the corporate sector and capital markets are leveraged, the easier it will be for all to work with the EU Taxonomy. Thus, the SFWG encourages the EU to consider aligning existing regulatory schemes in primary sectors (e.g. agriculture and food standards and labels) to include EU Taxonomy-compliant elements. At its core the EU Taxonomy is an indication to the primary sectors on how to adapt their production processes and could ultimately be the basis for consistent regulation of those sectors.

2. **Flexibility and harmonization — towards a principles-based global standard**
   The SFWG does believe that some of thresholds used in the Taxonomy (e.g. for electricity generation or cement, steel and aluminium production) may be very ambitious and potentially unrealistic—particularly for the production of electricity from hydropower and gas combustion, as well as for markets that may not be as far along transition paths as some in Europe. Thus, while recognizing the EU Taxonomy is intended for the European market, it may be useful to consider through discussions in the emerging EU International Platform on Sustainable Finance how the EU Taxonomy might be progressively adapted as a template for other markets. In particular, the "do no significant harm" principles are mainly based on EU rules, making full endorsement by non-EU firms highly challenging.

   A flexible approach that takes into consideration the different status and speeds among countries and that is locally adapted to them could therefore be helpful. Given this asynchronicity and heterogeneity among economies, local taxonomies and rules adapted to local conditions may be needed, at least in the beginning. Moreover, it would be difficult to comply with the EU Taxonomy if it were to be transposed mechanistically to emerging countries. For example, the mandatory due diligence required of market participants in determining whether investee/borrowing companies endorse all International Labour Organisation (ILO) core labour conventions may be challenging in certain jurisdictions. This is particularly true for investments in certain emerging markets, where the data on the extent to which the local companies respect those standards are often unavailable. The IIF would be pleased to bring views from its global members into such discussions so that perspectives from different geographies can be heard.

   More broadly, the SFWG would strongly advocate global cooperation and coordination toward progressively achieving common principles-based global standards to avoid fragmentation of markets—a theme regularly echoed in core IIF work on market fragmentation. This is particularly true as other markets (e.g. Canada) have indicated their desire to develop their own taxonomies; better alignment of other taxonomy systems (e.g.

in China) would also be very beneficial. Thus, the SFWG encourages discussion within global economic governance and steering bodies (e.g. G20, FSB, TCFD, ISO Technical Committee) to coordinate and to align efforts and potentially build on the EU Taxonomy for those jurisdictions inclined to take the same government regulatory approach as the EU.

3. **Encompassing all transition activities—a more holistic approach**
   The SFWG believes that it is vital to ensure that any taxonomy recognize the need to support transitions in key sectors over a period of years, in a way that will support important policy commitments aligned with the Paris Agreement and broader Sustainable Development Goals. Thus, the SFWG welcomes the efforts of the TEG to introduce transition elements into the EU Taxonomy—particularly through the concept of having metrics with thresholds that change over time as technological capabilities increase. While the SFWG recognizes that the TEG had to make choices and is trying to provide incentives to the market, some of the transition elements may also be very stringent (e.g. 50g $CO_2$/km for hybrid vehicles at present, with a threshold of 0 by 2025). Moreover, the definition of transition activities may be too restrictive as it only includes activities that have the potential, on a stand-alone basis, to be carbon-neutral in 2050. A more holistic approach integrating combinations of new and existing technologies and practices (i.e. electrification, hydrogen, sustainable bio-based feedstocks, product substitution, and carbon capture, utilization and storage [CCUS]) that has the potential to significantly reduce carbon emissions would be more pragmatic and effective.[1]

4. **Governance — including appropriate stakeholders and sectors**
   The EU Sustainable Finance Platform will play a key role in governing the EU Taxonomy going forward to drive this transitional element. Thus, the SFWG encourages the establishment of a robust and clear governance structure including oversight of future updates to the 2019 TEG report and outreach to the industry from the outset of the Platform, with dialogue established at a high level — given the need for clear engagement from coalitions of CEOs, board members, and industry bodies. Moreover, care should be taken to allow the views of millennials to exert appropriate influence on the Platform, and multiple stakeholders should be included within public-sector expert working groups via a transparent application process.

   The Platform should also take into consideration sector-specific factors. For example, as insurers follow a long-term business model, they have the potential to redirect capital flows to greener activities in support of the transition. Yet the perceived attractiveness of investing in sustainable assets can be influenced by a number of factors. As such, recognition must also be given to:

[1] The IPPC presented in 2018 “Characteristics of four illustrative model pathways to achieve the net emissions reductions that would be required to follow a pathway that limits global warming to 1.5°C with no or limited overshoot. All pathways use Carbon Dioxide Removal (CDR), but the amount varies across pathways, as do the relative contributions of Bioenergy with Carbon Capture and Storage (BECCS) and removals in the Agriculture, Forestry and Other Land Use (AFOLU) sector.” Page 16 of the Summary for policymakers: here and here.

- The supply of sustainable investment assets (risks, return profile and tenor as insurers' approach to ALM involves duration matching assets to liabilities);
- Accounting rules and regulation (e.g., market consistent valuation of liabilities under Solvency II); and
- Capital charges that properly reflect asset risk, i.e. not based on a binary green/brown classification.

5. **Capturing a broad range of financial products and services**
The SFWG continues to believe that many forms of sustainable finance can support transitions: it should also be possible for these to be recognized in the overall EU Sustainable Finance Action Plan. In particular, work done by investment banks to finance transitions by corporate clients (e.g. through green bonds and loans) and engagement efforts by asset owners and managers to support companies in developing transition plans (e.g. through efforts such as Climate Action 100+) are key to supporting the re-engineering of primary sectors and market activities over a span of decades. Financial institutions have a crucial role to play in supporting client efforts to develop transition technologies, which includes augmenting their operational and value chain energy efficiency over the medium-to-long term. Thus, the SFWG encourages the EU not to use the EU Taxonomy—which is focused on a binary approach—as the basis for all elements of its Sustainable Finance Action Plan, in particular its reporting requirements for financial market participants. As noted in our March 2019 letter, we believe that an effective taxonomy should look beyond defining what is or is not green, instead seeking to capture the full landscape of sustainable finance activities including the need for transition. Furthermore, the proposed Taxonomy would be most effective if it were to ensure sufficient flexibility to foster future disruptive innovation, rather than constraining or restricting new financial services and solutions from emerging. Other forms of finance and long-term strategies towards achieving the Paris Agreement should be recognized as sustainable as well.

6. **Client disclosures, reporting structures and data availability**
The SFWG notes that the activities-based approach of the TEG means there is a high degree of reliance on corporate disclosure to identify the percentage of revenues attributable to EU Taxonomy-compliant activities. The SFWG recognizes the corresponding updates made to the non-binding guidelines for the EU Non-financial Reporting Directive. However, the very fact that these guidelines are non-binding means that the information may not be readily available in the marketplace in the near term. Similarly, due diligence and verification of "do no significant harm" criteria may be disproportionately difficult for globally active asset management businesses in the absence of binding reporting standards.

   In addition, SMEs in particular face an important challenge regarding the disclosure of climate change related information, given their lack of capability to generate and process this kind of data. Authorities and the private sector will need to assist SMEs in the disclosure of comprehensive information. All these considerations may present challenges to rapid and reliable implementation of EU Taxonomy-based disclosures as contemplated in the current drafts of the Taxonomy Regulation. A robust market data system will need to be developed, including third party certifications where those are prescribed by the EU Taxonomy requirements. Technology-based solutions (e.g. big data, blockchain) may be a further avenue for mitigating reliance on client disclosures, while also reducing verification costs, and the TEG may wish to consider this when assessing the potential use of relevant metrics and indicators.

Thus, the SFWG encourages the EU to consider staging disclosure requirements to facilitate smooth uptake in the market. Financial firms are heavily reliant on disclosures from clients in order to meet the contemplated requirements; until such data are readily available it will not be possible to meet these requirements. This underscores that the use of the EU Taxonomy should remain voluntary, at least until all relevant green criteria are included and satisfactory reporting structures are in place. ESG research and rating firms, as well as credit rating agencies, can help bridge such data gaps; consideration should be given to including such firms in the Platform, subject to a public vetting process. The SFWG also notes that the disclosures required of corporates will often be backward-looking, static, and footprint-based rather than forward-looking and transition-based. For this reason, the SFWG encourages that transition-focused sustainable finance be recognized in the broader EU Action Plan regulatory framework and supports forward-looking reporting, in line with the TCFD recommendations. Towards this end, measures such as surveying corporations on whether they have set science-based targets should be considered.

7. **Looking ahead: other applications of the EU Sustainable Finance Taxonomy**

The SFWG notes that work is already underway to explore additional uses of the EU Taxonomy beyond what is currently contemplated by the TEG in the green bond and benchmark reports. In particular, the SFWG notes that some banks will be exploring the application of the EU Taxonomy to bank balance sheets in conjunction with UNEP FI. Similarly, the SFWG is exploring, in conjunction with the European Banking Federation, methods to recognize transitions toward greener bank balance sheets, including by developing a framework to track climate finance. The SFWG will be pleased to share this work with various European bodies including the European Banking Authority (EBA) as they work on their reports mandated by the Capital Requirements Directives (CRD) and the Capital Requirements Regulations (CRR), as well as the NGFS.

Looking ahead, there have been suggestions that the Taxonomy be considered as the basis for prudential adjustments or factored into climate scenario analyses and stress tests. As a general principle, the SFWG would suggest that time be allowed to road-test the EU Taxonomy before it is applied to other regulatory and supervisory work, and before expanding it to further environmental objectives. Furthermore, prudential regulation should not attempt to support green or penalize brown assets (e.g., via adjusted capital requirements) purely on the basis of their classification. Any changes should be based on compelling evidence regarding the risk profile of a given asset class. While the SFWG fully acknowledges the importance for finance to contribute to sustainability-related goals, this consideration should not override the essentially risk-based nature of investment and underwriting decisions. In the same vein, good data and comprehensive analysis should be a precondition to climate-related related stress tests or adjusting capital requirements; embedding climate-related risks in stress tests in a nascent phase might not prove to be the best approach. Forward-looking indicators, tools and scenarios adapted to climate risks—which to a large extent have yet to be adequately developed—are also required. The SFWG recommends that the EU discuss all these considerations with peers in the context of the NGFS workstreams.

On behalf of the IIF Sustainable Finance Working Group, we hope that these private-sector perspectives will contribute to your work on developing the EU Taxonomy and broader Sustainable Finance Action Plan. We would appreciate the opportunity to discuss any of these matters further and invite you to contact us should you have questions or comments.

Sincerely,

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