



FESE Position on Sustainable Finance - Proposal for Low carbon and Positive Carbon Impact Benchmarks

Brussels, 18th October 2018

1. Introduction

FESE Members provide indices that include green, sustainable and social benchmarks. This position paper presents FESE's view on the Commission's proposal to amend the Benchmarks Regulation (BMR) and to define 'low carbon' and 'positive carbon impact' benchmarks, as well as the amendments tabled by the European Parliament's Rapporteur, Neena Gill, in her draft report.

Understanding indices and climate change policies

Benchmarks are used to provide investment opportunities and serve as measures of economic performance. However, it is important to recognise that benchmarks reflect the underlying market activity and that simply changing the composition of benchmarks will not in and of itself change the performance of an economy.

In respect of climate change, real change can only be achieved by adopting sector specific regulations and tax incentives to promote the fight against climate change. Such policies will have an impact on companies' business models and either lead to a decline of certain businesses or a change of business strategy. This will have effects in terms of determining the largest companies in any given economy, which will in turn lead to a change in the composition of benchmarks. On the contrary, changing benchmarks while leaving market fundamentals unchanged will only mean changing the measurement.

Moreover, not all benchmarks are based on assets which can easily be deemed as belonging in one category or another. Such benchmarks include interest rate benchmarks and commodity benchmarks. If the use and provision of this type of benchmark were to be constrained, this would have consequences for market stability and systemic risk as many benchmarks are used to hedge risk appropriately. It should also be kept in mind that labels and standards not reflecting market fundamentals can distort economic incentives and lead to a build-up of bubbles in the economy.

Definitions of regulated data within BMR

While FESE fully supports the objectives of BMR to ensure the accuracy, robustness and integrity of benchmarks and of the benchmark determination process, we welcome the recent tabling of amendments in the scope of the ESAs review proposals to add further clarity to the definition of regulated data benchmark. We include our position on this topic in section three and take this opportunity to reiterate the need to address this issue during the current legislature.

2. Detailed position on the Commission Proposal

Definitions

The Commission has stated that the rationale for its proposals is a lack of "appropriate and objective low-carbon indices that could be used as a reference index" and that there is a risk of greenwashing as the levels of disclosures of methodologies are different. FESE supports this approach since, while there is currently a spectrum of low carbon benchmarks available to the market, consistently applied and clear definitions would be welcome. However, FESE believes that some adjustments could be made to the definitions.

Low Carbon Benchmarks:

FESE considers that the proposal to define low carbon benchmarks, where shares would be “selected so that the resulting benchmarks portfolio has less carbon emissions when compared to the assets that comprise a standard capital-weighted benchmark”, lacks clarity and runs the risk of facilitating evasion.

Taken in isolation, this provision could mean that any standard benchmark could qualify for the definition simply by omitting shares from a company with carbon emissions. However, the Commission also proposes a second set of conditions setting minimum standards to be defined through the use of Delegated Acts. While FESE considers that investors should be the ones to set exclusion criteria, should the criteria nonetheless be defined in legislation, it should be done within the political Level 1 framework.

Positive Carbon Benchmarks:

Regarding the definition of ‘positive carbon impact benchmarks’ which shall be “selected on the basis that their carbon emissions savings exceed the assets’ carbon footprint”, FESE deems it necessary that both companies’ planned activities as well as achievements on planned activities are taken into consideration when selecting the benchmark constituents. This information should be provided as auditable figures.

Transparency of methodology

Regarding the requirements addressing the transparency of methodologies, FESE considers that disclosures need to be well-suited to the respective target groups, whether it is information to be made public or to be provided to customers of benchmark providers. While benchmark providers are already very transparent and publicly disclose their methodologies - including information on the respective third-party data sources - certain proprietary data owned by benchmark providers are usually disclosed only to customers with whom they have contractual arrangements. However, data owned by third parties, such as data vendors and research providers, may usually not be disclosed at all.

In this light, we consider that some of the provisions proposed by the Commission are very far-reaching and consider that certain aspects of an index provider’s methodology cannot be published. For instance, disclosing the positive carbon impact of each underlying asset instead of aggregated figures, as suggested in Recital 17, may breach administrators’ contracts with external data providers. Therefore, FESE considers that disclosure requirements for the methodology should be further streamlined to achieve the objectives the Commission is targeting, while respecting the confidential nature of some aspects of the methodology.

Regarding the criteria and method for the weighting of the underlying assets of a benchmark, FESE considers that it is important to take into account the fact that basic weighting factors as diversification and risk limits can be mutually exclusive with ESG considerations.

Listed issuers

Finally, as a general point, FESE would caution against introducing significantly higher disclosure requirements on listed issuers alone as this could introduce a barrier to listing. We believe that the relative attractiveness of public markets should be preserved and that it should not be possible to avoid complying with further disclosure requirements by remaining private as this would result in decreased overall corporate transparency. Since listed companies are, in the vast majority of cases, included in benchmarks, some of the amendments currently being discussed would mean introducing significantly higher disclosure requirements for listed companies compared to private ones.

Necessity to link the proposal to the taxonomy proposal

FESE considers that a clearly defined taxonomy, whereby agreement on what constitutes environmentally sustainable assets and activities (existing, planned and achieved ones) is

found, is a necessary starting point for other actions, including those related to the proposal on low carbon and positive carbon impact benchmarks.

While the Commission's legislative proposal on the taxonomy aims first to focus on establishing a unified classification system related to climate change, there is also an important need for classification of environmentally and socially sustainable activities. We consider that it is important to align the timeframe and calendar of the taxonomy workstreams and, once finalised, other legislative proposals on sustainable finance should build on the taxonomy, including the proposal to amend BMR.

FESE is concerned that if, instead of tying these two legislative proposals together, separate standards for benchmarks providers are created this could produce a disconnect between benchmarks and the underlying market. Such a development would be particularly unfortunate as the purpose of benchmarks is to measure developments in the markets and it is crucial that standards for classification of assets applying to the market as a whole can be reflected by benchmarks providers, rather than these being subject to a different set of standards. Considering that the taxonomy would also include relevant disclosure metrics and to avoid overlapping, potentially conflicting disclosure requirements, FESE would suggest not to add further disclosures which go beyond those already required within BMR Article 13.

3. Detailed position on the Rapporteur's Draft Report

On 27 September, the Rapporteur in the European Parliament, MEP Neena Gill, published her draft report. As part of her proposals, she suggests significantly extending the scope by requiring that all published benchmarks would have to be positive carbon impact benchmarks and follow a standardised methodology developed by the Commission in a Delegated Act by 2022.

While FESE agrees with the intention to promote full application of the Paris Climate Agreement and fully supports promoting the necessary transition towards a low-carbon economy, the proposal does not fully reflect the fact that the purpose of benchmarks is to measure market realities, not shape them, as outlined in the above introduction. Therefore, FESE would like to provide some further input to inform policy discussions currently taking place.

Definitions and scope

Rapporteur MEP Gill is proposing an amendment requiring all benchmarks to be positive carbon benchmarks by 2022. Requiring such a significant change of existing benchmarks' methodologies would drastically change the measurement of market performance which would then be based solely on the performance of an issuer's carbon emission savings, at the expense of other underlying assets which reflect the diversity of financial markets and incentivise various investment decisions. Indices play an important role in a modern economy by making markets more transparent, facilitating diversification of investments and risk management, simplifying performance measurement, and supporting decision making for a wide range of people and institutions.

Furthermore, there is a significant lack of companies that fulfil the conditions currently proposed, which would lead to very few companies being allowed to be included in such benchmarks. The resulting benchmark would be significantly less diversified, thus increasing risk for investors. In case benchmarks could no longer be provided as a result or regulatory requirements, a negative impact on financial stability could not be excluded.

There are indices for almost all financial asset classes, as well as goods and concepts such as economic growth or job market data to serve different investor needs. This diversity is a prerequisite for benchmark administrators to effectively support the different needs of investors but would be made impossible by the Rapporteur's proposed amendment.

Methodology issues

FESE views some of the amendments tabled by MEP Gill in a similar light as the initial proposals made by the Commission detailed above, as they increase the requirements to disclose exact details of the methodology.

FESE is concerned that some of the proposals come close to mandating benchmarks providers to disclose publicly all relevant parameters of their benchmarks, which would challenge the business model of benchmarks providers as there would then be little to prevent replication by other actors. Moreover, benchmarks providers do not normally have licences to disclose information they use from third-party data providers.

It is very important not to mandate benchmarks providers to make disclosures on behalf of issuers or other third-party data providers, as this would significantly infringe ownership rights of third parties and may result in the unavailability of benchmarks in the future. However, usually third-party data sources can be approached for access to their data directly by users and these sources are disclosed in publicly available benchmark methodologies.

Standardised methodologies

In relation to the proposal for benchmarks providers to be required to follow a standardised methodology developed by the Commission in a Delegated Act, FESE considers that this type of provision would stifle innovation in the benchmark industry. While we fully agree that regulators should set regulatory frameworks to promote political objectives, it should not be up to the Commission to directly decide the business model of benchmarks providers.

Moreover, this type of measure should not be decided by Delegated Act, as the involvement of the co-legislator is limited. Finally, while Delegated Acts can be changed very quickly, which has the advantage of providing flexibility, the scope for possible changes may be very large meaning this type of process would not provide certainty for the industry in implementing required changes.

Investigation of the Benchmark Sector

The Rapporteur, in her draft report (amendment 18), proposes that ESMA and NCAs shall, two years after entry into force of the regulation, produce a report on the competitiveness of the benchmark sector and based on its conclusions, the Commission should be empowered to adopt measures by Delegated Acts to ensure fees are transparent, impartial and based on actual costs. It should be noted that while the report refers to the “rapid evolution in climate technology”, it in no way justifies the proposal to investigate the competitiveness of the benchmark sector.

Price regulation is a severe intervention in the market, which requires a very solid justification, for example a market failure. However, such conditions do not apply to the benchmarks sector as it represents a global market which has a wide range of providers providing millions of indices. Moreover, investors and product providers can choose from a broad range of comparable products subject to intense competition, which has resulted in significant decreased costs for EU investors.

Benchmarks are the basis for cost-efficient exchange traded funds (ETFs), that constitute passive investments. In recent years, development in passive investment has led to significant cost savings compared to active investment, as verified by many independent studies. It should also be noted that the cost for index licencing is negligible in comparison to the cost for asset management.

Introducing price regulation would subject European benchmark administrators to an artificial, anti-competitive disadvantage and deprive them of the freedom to offer innovative products at competitive prices. FESE therefore strongly disagrees with this proposal.

Moreover, it would not be appropriate to introduce intrusive measures through Delegated Act as this is a technical decision with limited involvement of the co-legislator. It should also be kept in mind that if it is indeed deemed that a sector is not sufficiently competitive, the Commission is always empowered to act through its competition powers.

4. Concerns regarding the definition of regulated data benchmarks

While FESE fully supports the objectives of BMR to ensure the accuracy, robustness and integrity of benchmarks and of the benchmark determination process, we have serious concerns regarding how the definition of regulated data benchmark has been interpreted since the conclusion of Level 1.

Under the current definition (Article 3.1 (24)), benchmarks based on regulated data sourced from the original source as outlined in the regulation, but from a technical service provider, would not be considered a regulated data benchmark. However, benchmark administrators, like many other Capital Market participants, rarely connect to all regulated data sources directly but usually obtain such data via data vendors. Data vendors act as the technical link between multiple trading venues and the benchmark administrator, without changing the original data content (e.g. price and volume data). This way of sourcing data reflects standard market practice for administrators to connect to numerous markets, enabling them to provide a broad variety of standardized products to the benefit of EU investors. However, some regulators have argued that this practice should be considered outsourcing. FESE does not share this view but considers that benchmark administrators obtaining regulated data via data vendors should continue to fall within the scope of ‘regulated data benchmark’, as long as the transaction data content itself (e.g. price and volume data) remains unaltered.

Moreover, it is important to consider that the BMR framework for regulated data benchmark was set considering that input data from trading venues is transaction based, supervised and already subject to stringent regulatory requirements under, among other pieces of regulation, MiFID II/MiFIR and MAR/MAD, which ensure the undisputed quality of regulated data. Receiving the data via a data vendor as outlined above does not in any way affect the data quality.

However, based on statements made during the scrutiny session of the European Parliament’s ECON Committee on 11 July and amendments tabled in the context of the ESAs review, FESE understands that there is support to address this issue through a Level 1 amendment to the Benchmarks Regulation. FESE strongly welcomes the willingness of policy makers to address this.

The Federation of European Securities Exchanges (FESE) represents 35 exchanges in equities, bonds, derivatives and commodities through 19 Full Members from 30 countries, as well as 1 Affiliate Member and 1 Observer Member.

At the end of January 2019, FESE members had 8,648 companies listed on their markets, of which 13% are foreign companies contributing towards the European integration and providing broad and liquid access to Europe’s capital markets. Many of our members also organise specialised markets that allow small and medium sized companies across Europe to access the capital markets; 1,341 companies were listed in these specialised markets/segments in equity, increasing choice for investors and issuers. Through their RM and MTF operations, FESE members are keen to support the European Commission’s objective of creating a Capital Markets Union.