FESE Position Paper on the Final Draft RTS on SFDR Taxonomy-related Product Disclosures: Treatment of Derivatives

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Summary

- Derivatives play a central role in lowering market-based funding costs for actors in the real economy thanks to their risk-hedging function. Given the substantial financing needed for Europe's green transition, it is counterproductive to disincentivise the use of derivatives by market participants – especially within the sustainable finance regulatory framework created by the Taxonomy and Sustainable Financial Disclosure (SFDR) regulations.
- Due to the proposed calculation methodology, a draft RTS recently communicated to the Commission would tangibly disincentivise the use of derivatives by portfolio and fund managers in sustainable financial products in Europe. Under the proposal, the use of derivatives could only ever contribute negatively to the Taxonomy Alignment Ratio of the product or portfolio.
- FESE Members are firmly convinced that enactment of this proposal as drafted would be harmful to Europe's broader climate and sustainability goals. We therefore recommend that the calculation methodology be amended to recognise the role derivatives will need to play in securing market-based financing for Taxonomy-aligned investment activities.

The role of derivatives in (sustainable) finance

- The exponential growth of ESG markets over the past few years shows the need for forward prices for these assets and their related indices. Derivatives markets are a key component of mature secondary markets, and the recent growth in demand for listed ESG derivatives illustrates that these products are a core component of sustainable investment strategies, especially since the availability of liquid and transparent derivatives can fundamentally reduce funding and financing costs for share and bond issuers in the primary markets. Derivatives allow investors to hedge their exposures to newly listed companies or debt issuances, which is directly related to the amount of capital that investors can allocate to such companies, and in turn to the financing costs that these companies incur when raising capital.

- Considering the substantial financing needed for the sustainable transformation, it is imperative that the EU continues to lead the way by setting the right regulatory incentives for its financial markets. Taking this into consideration, we are rather concerned about the overall signal to the market that an unfair treatment of derivatives within the broader European Taxonomy/Sustainable Finance Disclosure regulatory

framework could cause, as seen in the draft RTS on sustainability-related disclosures at the product level.[1]

Negative implications of the current proposal

- Under the current RTS proposal, the Taxonomy alignment of certain specified financial products[2] is to be expressed via a ratio, namely the amount of assets in Taxonomy-aligned activities over total assets. Derivatives may not be included in the numerator on the basis that there is not yet a reliable methodology for assessing their Taxonomy alignment, i.e., they are not recognised as contributing to Taxonomy-aligned investment activities, but they must be included in the denominator as part of the total assets of the product or portfolio. This proposal incorrectly disincentivises the use of derivatives in the affected financial products, since any exposures to derivatives could only ever contribute negatively to the Taxonomy-alignment ratio. Moreover, the ESAs' justification of this exclusion of derivatives is insufficient, as no proper impact assessment of the broader economic implications of the possible trade-off between maximising the Taxonomy ratio and the use of derivatives has been conducted.
- If the draft RTS is adopted as proposed, we anticipate damaging impacts on the availability of funding for Taxonomy-aligned investment activities due to:
  - Increased costs for portfolio and product managers, as the use of derivatives as hedging instruments is implicitly discouraged. This will result in increased funding costs for environmentally sustainable investments in the real economy.
    - Derivatives (ESG and non-ESG) play an integral role in hedging portfolio risk, and therefore in reducing funding costs for Taxonomy-aligned economic activities. To take one example, green bond index futures may be used by bidding investors to hedge their exposures to a new green bond issuance. As market risk is reduced, offer prices can be raised. This translates into lower bond yields, and hence lower financing costs for the green bonds.
  - Cooling effect on the ESG derivatives sector, discouraging further R&D on Taxonomy-aligned derivatives supporting environmentally sustainable investments in the real economy, as well as on assessing the Taxonomy alignment of derivatives.

Key recommendations

- FESE is convinced that it is possible at present to assess the Taxonomy alignment of many derivatives, notably exchange-traded derivatives, and that they should therefore be included in the numerator of the ratios. A concrete example would be listed derivatives on single stocks, ETFs and indices because of their standardised nature and the possibility to calculate the Taxonomy alignment ratio. In principle, the same methodology could apply as for cash instruments. For this reason, we recommend allowing derivatives for which the Taxonomy alignment can be calculated to be included in the numerator. This would not only provide a more complete picture of the Taxonomy alignment of the product, but also incentivise the industry to further develop reliable methodologies while countering greenwashing and providing better and more reliable information to investors.

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[1] Draft Regulatory Technical Standards with regard to the content and presentation of disclosures pursuant to Article 8(4), 9(6), and 1(5) of Regulation (EU) 2019/2088 (JC/2021/50).

[2] A portfolio managed in accordance with Article 2(6) of the Regulation, an alternative investment fund (AIF), an IBIP, a pension product, a pension scheme, a UCITS, or a PEPP. (Article 2(12) of Regulation (EU) 2019/2088)

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- FESE believes that derivatives contribute to financing Taxonomy-aligned projects there exists methodologies to assess many categories of derivatives for Taxonomy alignment. To that end, derivatives should be able to be included on both sides of the ratio, i.e., not solely in the denominator. Importantly, derivatives for which Taxonomy alignment can be derived from the underlying asset or from a comparable asset should be reflected in both the numerator and the denominator.
    - It is already possible to assess the Taxonomy alignment of certain derivatives, particularly exchange-traded derivatives, and in many cases this methodology should not be as complex as envisaged. For example:
        - Futures and options on single stocks, ETFs and indices have as their underlyings products that can currently be assessed for Taxonomy alignment. These derivatives' exposure to their underlying can easily be measured using the notional amount or, for stock and ETF futures and options, the number of shares. This implies that a methodology to assess the Taxonomy alignment of these plain-vanilla derivatives contracts should be relatively straightforward to develop.
        - The proportion of Taxonomy-aligned activities in futures on ESG indices could be measured using the same methodology as for ETFs. ETFs' returns closely track a benchmark index. Via their holdings, which must be disclosed by law, it is possible to calculate the degree to which their investments are Taxonomy aligned. Futures on indices embedding certain ESG methodologies have the same characteristics as ETFs: since the underlying index must be UCITS compliant, its components, weightings, and methodology are also fully transparent, it is possible to calculate the degree to which the derivative is Taxonomy aligned.
- Should policymakers continue to be of the conviction that no reliable methodologies for assessing the Taxonomy alignment of derivatives currently exit, we would argue that derivatives should at minimum not be disadvantaged within the sustainable finance framework, which is the effect of the proposed ratio. Instead, in the interim derivatives should be excluded from the ratio entirely. While this is not the optimal long-term solution, the ratio in the current proposal is sufficiently detrimental to the ability of the financial markets to contribute to Europe's green transition that we believe even this suboptimal solution would be an improvement.
- If the Commission and ESAs still do not consider it possible to include derivatives on both sides of the ratio at present, we would propose an interim solution: the exclusion from the ratio of all asset classes that are not currently considered assessable for Taxonomy alignment, but for which methodologies could be developed in future. This should include at minimum sovereign bonds (as in the current proposal) as well as derivatives. This would mean that only qualitative disclosures on how derivatives are being used to attain respective objectives or characteristics would be included in the Key Information Documents for these products.
    - The short-term goals of this temporary solution would be to:
        - Help lower funding costs for Taxonomy-aligned activities by not discouraging the use of derivatives as hedging instruments.
        - Not disincentivise future R&D in the ESG derivatives space, including further work on methodologies for assessing Taxonomy alignment.
- Should derivatives not be included in the numerator at this stage, we would urge European policymakers and supervisors to revisit the question of how derivatives can be included in the Taxonomy alignment ratios in the near future. Excluding derivatives from

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the ratio altogether is not a preferred long-term approach, but rather an interim solution if derivatives cannot be included in the numerator at present.

- The inclusion of derivatives on both sides of the ratio will be of outmost importance as the regulatory environment matures. We stand ready to work with policymakers in devising an acceptable methodological approach.

The Federation of European Securities Exchanges (FESE) represents 36 exchanges in equities, bonds, derivatives and commodities through 18 Full Members from 30 countries, as well as 1 Affiliate Member and 1 Observer Member.

At the end of November 2021, FESE members had 9,236 companies listed on their markets, of which 16% are foreign companies contributing towards 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 capital markets; 1,421 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.

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