Amafi > Association française des marchés financiers
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FEEDBACKS TO EC

Sustainable Finance Initiative – Benchmarks Regulation

AMAFI Feedbacks

Association française des marchés financiers (AMAFI) is the trade organisation working at national, European and international levels to represent financial market participants in France. It mainly acts on behalf of credit institutions, investment firms and trading and post-trade infrastructures, regardless of where they operate or where their clients or counterparties are located. AMAFI has more than140 members operating for their own account or for clients in equities, fixed-income products and derivatives. Nearly one-third of its members are subsidiaries or branches of non-French institutions.

AMAFI welcomes the opportunity to give feedbacks on European Commission proposed amendments to Benchmarks Regulation[1] (hereafter "BMR") to introduce EU harmonized standards for low carbon and positive carbon impact benchmarks. Indeed, AMAFI pays particular attention to the development of ESG criteria in the financial markets and welcomes this objective to develop sustainable investments which are vital for our future.

We share the views that EU harmonized rules for benchmarks with low or positive impact carbon related features should seek to address both the risk of 'green washing' and the current lack of benchmarks comparability for investors. However, in line with the Commission's preferred approach (Option 4 a.) we believe that the forthcoming standards should favour flexibility over rigidity. Indeed, flexibility is necessary for benchmark administrators to adapt their offerings to the diversity of investors' requests. It is also needed to keep the standards updated since this field keeps evolving at a fast pace.

Also, returns on investment remains key for investors in their investment decision making and requires administrators' ability to innovate and tailor benchmarks with low or positive carbon related features in the investors' best interest. Towards that end, AMAFI believes that it is critical that forthcoming rules do not result in too prescriptive methodologies for selecting and weighting relevant assets to protect such innovation and tailoring. For the same reason, we believe we should avoid having to standardized low or positive carbon impact benchmarks but encouraging a sufficient wide offer of carbon impact benchmarks to find the most suitable to investors' objectives.

Additionally, we welcome the Commission's intention to leverage on the existing BMR framework to introduce the new standards. However, AMAFI believes that prior to adding new requirements; the Commission should consider adapting already implemented standards for administrators to the provision of low carbon and positive carbon impact benchmarks. This would ensure consistency and avoid unnecessary duplication of regulatory burden for benchmarks administrators.

[1] Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014.

Finally, AMAFI drafted this answer with the key principles as developed below:

- Acknowledge diversity in investors' approaches to portfolio decarbonization.
- Rely on BMR to avoid unnecessary duplication of regulatory burden.
- Strike the right balance between standardization and investors' performance.
- Anticipate future improvements in carbon research, starting with enhanced companies' carbon data disclosure[2].
- Acknowledge that carbon data disclosure, like ESG data disclosures, creates biases towards large cap, geographies, developed countries, sensitive sectors etc.

KEY PROPOSITIONS FOR DELEGATED ACTS

AMAFI understands that the Commission will rely on the group of technical experts' conclusions to prepare Delegated Acts. However, AMAFI would like to take the opportunity of this response to make comments and recommendations on the definitions and the methodology to design low carbon and positive carbon impact benchmarks. AMAFI's main recommendations are summarized below:

- Definitions :

    - AMAFI agrees with the Commission's proposal to make a clear distinction between low carbon and positive carbon impact benchmarks. Nevertheless, the low carbon benchmark bucket would not and should not be homogeneous. It requires a high degree of customization to meet the diversity of investors' needs and should go with flexible standards.

    - The proposed definition of positive carbon impact benchmark is questionable to the extent that some benchmarks may also be compliant with the 2°C objective in the Paris Climate Agreement although companies are not saving more carbon emissions than their carbon footprint. Moreover, AMAFI believes that the definition of this category needs more clarification to avoid misunderstanding and increase the market's homogeneity.

    - AMAFI welcomes further clarification that benchmarks acquire the low and positive benchmark status only on an optional and not on a mandatory basis. It should be emphasized that the application of the low carbon and positive carbon definitions is optional. The reason being that if benchmarks were required to automatically become low-carbon benchmarks or positive carbon impact benchmarks if they fall within the definition it would hinder innovation. Administrators should only be required to comply with these additional requirements to the extent they wish to be able to designate their benchmark as a low-carbon benchmark or positive carbon impact benchmark.

- Input data

    - Administrators need flexibility in selecting data providers. For example, they can be allowed to follow the usual criteria of BMR such as transparency and robustness of providers (*BMR, art. 11.1*).

    - The carbon footprint measures should be defined in the methodology but emissions caused by a company's customers (scope 3) should not be a must have.

[2] A significant amount of data is not yet made publicly available and is instead estimated by research agencies.

- Any use of companies' projected emissions should be specified in the methodology and explained although widely recognized scenarios by sector should be favored.

- Assets selection & weighting

  - If carbon data is used to select components and determine weighting, the following elements should be described in the methodology, so users are able to measure the difference between low carbon benchmark and its equivalent standard benchmark:
    - any thresholds used in the selection:
    - whether and how carbon data impact the weighting; and
    - any applied carbon momentum strategy.

    Non-carbon related financial criteria applied to select components should also be specified in the methodology, as for any type of benchmarks, for users to track the respective impact of carbon data and financial criteria in the components' selection & weighting.

- Exclusion principles and sector selection

  - AMAFI believes that an exclusion criterion should firstly be based on carbon impact and above all avoid potential arbitrary exclusion (for instance, exclusion not based on objective methods).

  - Sectors' exclusion should be specified and explained as well as any companies' bucketing based on their "green" or "brown" revenues and in consistency with the forthcoming EU classification systems for sustainable activities.

  - Nevertheless, for AMAFI it is essential that the administrator retain flexibility on how this requirement is carried out. For example, flexibility in the selection of companies for positive carbon impact benchmarks is key as in the short term, it will be very challenging to show components' positive carbon impact in the absence of stable and complete data and before the EU classification systems for sustainable activities is adopted.

- Additional elements to consider

  - AMAFI strongly suggests to formally take into account the 2°C objective Paris Climate Agreement including making references to it in the future delegated acts for selection, exclusion and weighting of assets.

  - Green bonds benchmarks should also be integrated into this proposal.

  - Compensation schemes via carbon emission certificates should be accepted and disclosed in the methodology.

- Disclosure carbon exposure for low carbon benchmarks: this disclosure should only be optional for Benchmark administrators of low carbon benchmark given its challenging computation and still questionable value. This would otherwise add an unnecessary regulatory burden to administrators without genuine value for investors.

- Governance: methodology rectification or enhancement guidelines should be allowed to keep track with the ever fast evolving carbon research.

Comments and questions on the two categories defined in the EC's Proposal

<u>*Article 1.1 of EC's Proposal*</u>:

*'**low-carbon benchmark**' means a benchmark where the underlying assets, for the purposes of point 1(b)(ii) of this paragraph, are selected so that the resulting benchmark portfolio has less carbon emissions when compared to the assets that comprise a standard capital-weighted benchmark and which is constructed in accordance with the standards laid down in the delegated acts referred to in Article 19a(2); (23b)*

*'**positive carbon impact benchmark**' means a benchmark where the underlying assets, for the purposes of point 1(b)(ii) of this paragraph, are selected on the basis that their carbon emissions savings exceed the asset's carbon footprint and which is constructed in accordance with the standards laid down in the delegated acts referred to in Article 19a(2).*

These two categories reflect two distinct objectives:

- Low carbon benchmarks reflect the desire of investors to reduce the transition risks of an exposure to carbon intensive companies (notably the stranded assets risk);
- Positive carbon impact benchmarks reflect a stronger focus on impact and climate change reduction concerns.

While it is useful to distinguish two broad categories, underpinned by two different objectives, one must keep in mind that benchmark providers, answering investors' expectations, are in fact moving towards increasingly customized strategies. Most benchmark already available would fall into the low carbon category, as they are based on available data and initial investor demand. But investor demand is now evolving towards more sophisticated strategies, as information and education is developing around these topics.

The second category would mostly comprise current "clean technology" sector-based benchmarks.

Additionally, the FAQ on financing sustainable growth[3] reiterates that only positive carbon impact benchmark could be compliant with the 2°C objective in the Paris Climate Agreement. However, AMAFI does not totally agree with this assumption. We believe that a company selected in a low carbon benchmark that have a projected carbon footprint improving could be compliant with the 2°C objective even though its carbon emission savings are lower than what needed to be selected in a positive carbon impact benchmark.

Recommendations for low carbon and positive carbon impact benchmark methodologies

1. Input data

1.1. Data providers

AMAFI believes that the methodology of low carbon or positive carbon impact benchmarks should include the name of extra-financial rating agencies selected as carbon data providers, and a mention as to where find more information on this provider (typically a link to the provider's website).

[3] Frequently asked questions: Commission proposals on financing sustainable growth, 24 May 2018 (link).

Given the continuous improvement in carbon data disclosures by companies (notably in their coverage by extra-financial rating agencies) and in order to get the most comprehensive set of data, AMAFI believes that at this point in time it is not appropriate to select a limited list of extra-financial rating agencies approved as carbon data providers. It neither seems appropriate to determine a limited list of mandatory criteria to be applied by benchmark administrators in selecting such providers. Administrators of benchmarks should however apply the usual selection criteria that will let them meet the data quality requirements laid out of BMR, such as: expertise (as reflected in the background and credential of a providers' teams), transparency (as reflected in the publication of the provider's methodology to collect and analyze carbon data), robustness (reflected in the provider's number of years of existence, staff count, or soundness of financial results).

1.2. Scope of carbon emissions

AMAFI feels that the methodology of low carbon and positive carbon impact benchmarks should specify the scope of emissions used (Scope 1[4] / Scope 2[5] / Scope 3[6] / Scope 4 or "avoided emissions").

As there is still potential heterogeneity on the definitions of carbon emission scopes, it would also be preferable to include in this methodology a definition of the considered scope(s) (directly, or by reference to publicly available information from the selected provider).

In line with the spirit of "Option 4a" retained by the EC (set minimum standards, without creating undue constraints at this time), and while there is a growing interest of investors to use Scope 3 emissions in indices, AMAFI recommends to make it optional to use these in low carbon and positive carbon impact benchmarks' methodologies. The greenhouse gas protocol itself questioned the relevance of using Scope 3 emissions to compare companies' emissions[7].

2. Selection and weight calculation criteria

For AMAFI, the methodology of low carbon and positive carbon impact benchmarks should specify whether carbon data is used in the selection of eligible components and/or also to determine their weights in the index.

- When carbon data is used in the selection of eligible components, the benchmark's methodology should specify any threshold used in the selection.
- When carbon data is factored into the determination of the weights of eligible components, the benchmark's methodology should comprise formula, which explicitly lay out how carbon data impact the components' weights.

The methodology should also specify whether a carbon momentum strategy is applied, such that past increase or decrease in carbon emissions would be considered in selecting or weighting the benchmarks' components, notably with a view to foster a continuous improvement approach.

Finally, the methodology should enable users to compute the number of components meeting the carbon selection criteria, and compare it to the number of components in the initial benchmark universe.

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[4] Emissions caused by a company's customers.
[5] Indirect emissions generated by the supply of raw materials or other "input" procured by the company upstream in order to produce its products or deliver its services.
[6] Emissions caused by a company's customers.
[7] "*The Corporate Value Chain (Scope 3) Standard is designed to enable comparisons of a company's GHG emissions over time. It is not designed to support comparisons between companies based on their scope 3 emissions. Differences in reported emissions may be a result of differences in inventory methodology, company size or structure. Additional measures are necessary to enable valid comparisons across companies, such as consistency in methodology, consistency in data used to calculate the inventory, and reporting of intensity ratios or performance metrics*" (*Greenhouse Gas protocol, FAQ, Question 7* – link).

3. Exclusion requirements

AMAFI thinks that the methodology of low carbon and positive carbon impact benchmarks should enable benchmark users to understand if a 'best-in-universe' or 'best-in-class' approach is adopted.

If some sectors are excluded from the benchmark, the list of excluded sectors should be specified, with a definition or reference to the considered sector breakdown (using, for example, Global Industry Classification Standard - GISC - sectors or sub-sectors). The reference to excluded sectors should be made according to the EU classification system for sustainable activities.

The benchmark's methodology should also specify if, in order to foster a forward looking approach and encourage future carbon emission reduction, there is a bucketing of companies according to their "green" or "brown" revenues, in order to favor the former in the selection of the benchmark's components. In that case, the methodology should clearly define "green" or "brown" revenues (directly, or by reference to publically available information from the selected provider).

4. Sector selection

AMAFI believes that the future Regulation should allow several possibilities to select companies for positive carbon impact benchmarks. For example, a benchmark that selects components based on their percentage of revenues in sectors that contribute to carbon emission reductions (for example, 'clean techs' sector) should fall into this category. Again, the reference to selected sectors should be made according to the EU classification system for sustainable activities.

5. Specific case of Green Bond benchmarks

Green Bonds are "Use of Proceeds" bonds intended to encourage sustainability and to support climate-related or other types of special environmental projects. AMAFI considers that those financial instruments are essential to support transforming European economy into a greener, more resilient and circular system as well as an opportunity to provide concrete solutions to respond to climate change. AMAFI would thus like to see them integrated in the low carbon benchmarks and positive carbon impact benchmarks talks.

This must be closely linked to the item in the EC action plan addressing good practices in terms of reporting and disclosure as well as impact measurement to be applied by issuers of Green Bonds. The implementation of green bond benchmark guidelines are dependent on the green taxonomy entailed in the EC action plan.

As Green Bonds primarily target green projects, which an issuer reports will be financed or refinanced through the bonds, it is important that even green bonds from companies in "non-green" sectors be eligible to Positive carbon impact benchmarks, as long as they respect the good practices of the Green Bonds market. These include notably: financing of eligible green projects, and provision of a second party opinion.

6. Disclosure of the carbon exposure of the low carbon benchmark

In the space of sustainable investment, there is increasing attention to carbon exposure measurement, and to disclosure on such exposure. While this is a good practice, there is still a lot of debate as to the relevance of such carbon exposure measurement for a whole benchmark, or as to the best way to compute it.

The main reasons for debates as to the relevance of measuring a benchmark's carbon exposure are, in our view:

- Some data is still lacking and there is a wide disparity in data availability between underlying assets.
- Measurement of avoided emissions is especially controversial. In particular, creating green capacity is not necessarily synonymous of carbon emission avoidance).
- For most of benchmarks, it is still challenging to measure the carbon exposure.

That is why, for AMAFI, adding a mandatory disclosure requirement for administrators of low carbon benchmarks on their carbon exposure, seem, at least at this early stage, inappropriate since it could have detrimental effects on promoting more responsible benchmarks. We also believe that investors should be able to choose between low carbon benchmarks available even those that do not disclose carbon exposure. Similarly, we believe it should be left to the administrator to disclose carbon exposure of its benchmark.

If a benchmark administrator chooses to disclose the benchmark's carbon exposure in the methodology, suggested good practices are as follows:

- The methodology should specify where the information will be published, at which frequency.
- The methodology should lay out how the carbon exposure will be computed, notably leveraging on existing European methodologies approved by the Commission and largely used by corporate companies to calculate their environmental performance (such as the Product Environmental Footprint and the Organization Environmental Footprint).
- The report should seek to compare the considered benchmarks' carbon "performance" with that of a relevant standard benchmark (for example calculating the carbon footprint -or carbon risk, or carbon savings…- of each benchmarks' underlying components, and comparing the result against relevant standard benchmark).
- The report should seek to track record previous years' results in order to foster improvements.

7. Impact of incorporation of financial filters if any

In line with the methodology transparency requirements laid out by BMR, the methodology of low carbon benchmarks shall specify the non carbon-related financial criteria applied to select the components (for example: Average Daily traded Volume, liquidity, sector & country diversification, historical volatility or dividends).

In the case of low carbon benchmarks, the methodology should enable benchmark users to understand the order in which carbon-related and financial criteria are applied, and their respective impact in the resulting components' selection and weights.

8. Carbon benchmarks' governance

In line with the governance requirements laid out by BMR, the methodology of low carbon benchmarks shall specify the process to authorize and apply a rectification of past benchmark values, or an enhancement of the methodology for future benchmark calculations.

Taking into consideration the fast moving nature of carbon research, the governance of low carbon benchmarks should define rectification or methodology enhancement guidelines, which enable benchmark users to benefit from the latest improvements, while avoiding unjustified discretion from benchmarks' administrators.

9. Others

9.1. Update frequency

The benchmark's methodology should disclose the frequency of the review of the components according to the carbon selection criteria.

9.2. Taxonomy

AMAFI wishes to outline that the regulation proposal on taxonomy should be consistent with this proposal notably include and define a "low carbon" objective.

9.3. Benchmark methodology process

To improve public transparency of benchmark methodologies, there are a lot of disclosure and communication requirements applicable to administrators. This needs to be paired with a certain level of flexibility for the administrator. For AMAFI, attention needs to be paid to not impose rigid rules which would ultimately lead to the commoditization of ESG, low-carbon or positive carbon index construction and reduce the value-added provided by administrators constantly proposing new benchmarks suitable to evolving needs of investors and sustainable economic development.

In line with the above, AMAFI would also likes to stress that flexibility is key and would caution against rules that require specific carbon methodologies or favor data that cannot be readily or affordably accessed administrators.

9.4. Transitional period

AMAFI seems to understand from the proposal that the amendments to BMR will come into force and apply from the day following their publication in the Official Journal. This would mean that any administrator that produces a "low carbon benchmark" or a "positive carbon impact benchmark" might immediately be required to comply with the obligations in relation to methodology and the requirement to publish a benchmark statement. This would not leave enought time for administrators to comply with those new requirements.

Similarly, if any non-EU benchmark administrators have already obtained recognition or endorsement by the time these changes come into effect, this could have an impact on that recognition or endorsement (e.g., if the relevant regulator considers that they are no longer in compliance with obligations equivalent to those under BMR).

This issue could be addressed by giving administrators a transitional period within which to achieve compliance.