FESE

FESE response to ESAs consultation on the review of the SFDR Delegated Regulation

Brussels 4th July 2023

Executive summary

FESE appreciates the ESAs taking a step forward and including derivatives in the PAI indicators as well as in the Taxonomy-alignment and share of sustainable investment ratios, reflecting derivatives in both the numerators and denominators. However, clarity is still lacking on how to include them.

Our response reflects our key observations and recommendations to ensure a fair approach which is aligned with the potential role of derivatives in contributing to sustainability:

- Derivatives should be looked at comprehensively, i.e. also with respect to their positive contributions. This is not reflected in the ESAs' current approach, which mainly focuses on the negative contribution of derivatives due to greenwashing concerns. Derivatives also contribute to and facilitate the sustainability and green transition. This misleading bias towards derivatives is still present vis-à-vis addressing PAI ratios versus Taxonomy-alignment and sustainable investment ratios.
- The final decision on the netting approach should be carefully scrutinised with the market before its adoption. In relation to PAI, the provisionally excluded short positions under the numerator of PAI indicators can still contribute to sustainability even if the underlying does not. Similarly, on the other side, the exclusion of long net exposures in the Taxonomy-alignment and sustainable investment ratios would also be unfair, as if derivatives in these ratios can only ever have negative ESG impacts. Until a decision is taken following the needed scrutiny with market players, we see merit in a flexible approach. The same netting approach should ideally be reflected on all the above ratios for harmonisation and equal treatment.
- It is misleading to include derivatives with 'any' kind of underlying into PAI calculations, as some are Taxonomy-neutral (e.g. interest rates, commodities, Forex) and they are not considered in any other sustainability ratio. However, the exclusion from the numerator of the PAI ratio of those exposures that do not ultimately result in physical investment in the underlying security could be limiting. Physical ownership does not necessarily demonstrate sustainable impacts and should not be considered as the criterion for inclusion/exclusion. We also believe it would be reasonable to include underlyings in companies' "equity" and "debt" asset classes of the derivatives proportionately in all PAI, taxonomy-alignment and sustainable investment ratios.
- We welcome the proposed calculation methodologies to convert derivative positions into equivalent underlying positions in PAI calculations to reflect derivatives' exposures in portfolios. These could also serve as an adequate starting point for Taxonomy-alignment and sustainable investment ratios. Alignment among all ratios is desirable. We would also encourage the inclusion of risk-based methodologies with respect to bond futures and interest rates futures, and would appreciate more clarity on the notion of 'plain vanilla' derivatives in the methodology. Before the proposed conversion methodologies are taken on board, the netting methodology must be decided.

ESAs questionnaire

Technical revision of the PAI framework

Q14 Do you agree with the proposed treatment of derivatives in the PAI indicators or would you suggest any other method?

In the current sustainable finance framework, derivative instruments are neither reflected in sustainable investment ratios, i.e., PAI ratios, nor reflected equally in numerators as well as denominators of sustainable investment ratios, i.e., GAR/GIR. Leaving derivatives out of the sustainable investment ratios or disincentivising their use undermines the overarching sustainable investment movement and green transition. In this consultation, we appreciate the ESAs taking a step forward and including derivatives into the framework and the PAI ratios, as well as reflecting them in both the numerator and denominator of these ratios.

This initiative draft addresses the primary concern of "including or excluding" derivatives in sustainable investment ratios. However, it seems clarity is lacking to pursue a single approach on the secondary issue of "how to include derivatives". For that reason, we put forward our arguments regarding the benefits and shortcomings of the various approaches, as well as certain improvement proposals for, certain aspects of this consultation.

Subsequently, we would like to share our key points on the current ESAs initiatives.

I.ESAs take initiative to reflect derivatives equally in sustainable investment ratios: Until now, derivatives have not been taken holistically into account and we commend the ESAs for taking the initiative to include derivatives in sustainable investment ratios in an equal manner, namely by including derivatives in both the numerator and the denominator of the relevant ratios. We fully support the direction the ESAs are taking.

II. Derivatives are considered sustainable investment vehicles per se: This notion is further substantiated regarding the PAI calculations, where the ESAs accept derivatives to "also constitute investment decision on sustainability factors" according to the proposed draft RTS recital (4) in this consultation. This further encourages the progress that derivatives themselves are also considered to contribute to sustainable investments. As a consequence, and as a next step, alignment in Taxonomy-aligned ratios would be required to reflect derivatives proportionately.

III. Careful scrutinising is required with the market before giving the final decision on the netting approach: In the current proposal, ESAs suggest including only "net long positions" of derivatives into numerators of PAI ratios. In our view, netting is a difficult approach, and it can be complex. We would abstain from mandating the use before scrutinising it extensively with the market players who might need more time to provide final views as it is difficult to distinguish between long and short positions.

Derivatives can contribute to sustainable objectives/adverse impacts, no matter in long or short positions, due to their mechanism, while potentially their corresponding underlying asset might not. The important point here is to focus on assessing correctly if the derivative instrument has a sustainable purpose in its use. If we focus shortsightedly on a single netting model, we may risk the assessment of the actual contribution of derivatives. Intelligence from the market also suggests that short positions could also be treated equally to long positions when they are used for hedging and ESG exposure purposes. Particularly these views have been reflected also in past consultation responses, as the ESMA consultation paper on guidelines on funds' names using ESG or sustainability-related terms closed in February 2023. Even if the feedback has been related to

SFDR/Taxonomy sustainable ratios, it should also be valid for PAI calculations in the current consultation at hand.

We believe that, currently, the market has not settled on a specific direction whether including “only net long positions” of derivatives into PAI ratios is sufficient because:

a) on the one hand, long positions can provide direct exposure for the sustainable underlying/adverse impact at the transaction.
b) On the other hand, always a green investment/adverse impact possibility exists with the cash received from shorting a derivative instrument which is overlooked by ESAs in the proposed initiative.

However, it does not seem right to ignore short positions totally. As explained, derivatives have different working mechanisms than other assets and short positions can still contribute to ESG objectives/adverse impacts indirectly even if the corresponding underlying does not. As long as the shortened position is not “brown”, it is technically not contributing to adverse impacts and, if at the end, the cash from the transaction is used for green investment, that derivative technically allows a direct contribution to sustainability. In our view, adding short positions into the numerator is a good step, but realistic and practical implementations of it should be considered given its technical complexity. We urge ESAs to carefully scrutinise with the market players on the inclusion of short positions into the numerators.

Another aspect raised in the consultation under the netting methodology is the initiative proposing to not allow the netting to go below zero. We cannot assess the immediate consequences of this rule. We would suggest the ESAs not dive into too many technicalities before concluding the discussion about net long/short positions. We would rather suggest taking this “zero flooring” approach as a second step discussion afterwards. In addition, we would appreciate it if the ESAs could provide more examples on the zero-flooring initiative because the various approaches discussed render it difficult to imagine immediately how to make all these calculations practically, given the introduction of various amounts of new technical approaches in this consultation.

All in all, given the derivatives’ mechanism, the final decision of how to include derivatives into PAI ratios cannot be seen as either a black or white decision. Our suggestion is to take into consideration both, the benefits, and drawbacks, of both approaches and come to a conclusion which fits the entire market before mandating the current proposals. For the moment, we do not see merit in a single approach but, instead a flexible approach, especially based on the different dynamics of various asset classes, can be considered with all pros and cons.

IV. Scope of derivatives

On top of the netting discussion above, we would also like to state that we find it reasonable to include underlyings in companies’ “equity” and “debt” asset classes of the derivatives into PAI ratios. Companies are real actors of the economy able to influence the re-allocation of capital flows toward the green sectors and they are capable of ESG assessments. Hence, equity and debt asset classes are the most obvious ones that can create an impact on company financing and are assessable against the EU Taxonomy/sustainability objectives, more so than other derivatives. The most important thing to be cautious of is that the inclusion of these asset classes should be reflected proportionately also to the other sustainable ratios, i.e. Taxonomy-alignment and sustainable investment, for equal treatment and harmonisation purposes.

V. Flexible methodologies are proposed to convert derivative positions into equivalent underlying positions in the portfolios: We emphatically commend the ESAs in proposing calculation methodologies to convert derivative positions into equivalent underlying positions to reflect derivatives’ exposures in portfolios. Until now, derivatives have not

been the focus and therefore the approach to which they could be captured has been neglected. With the proposal at hand, the ESAs provide a very good basis to allow for flexibility to the market with the proposed conversion methodology regulations per different asset/sub-asset classes referenced under AIFMD. We would nonetheless like to highlight that extending conversion methodologies are a good starting point and mostly fit for purpose, we would also strongly encourage including risk-based methodologies regarding bond futures and interest rate futures such as the delta approach or DV01 (dollar duration). The reason is that specifically for bond futures and interest rate futures, risk-based methodologies reflect the sustainable investment exposures of derivatives in the portfolios in a way that is closest to the actual exposure. Given that the aim is to provide market participants with methodologies to be used in the most meaningful way to reflect sustainable investment exposures of derivatives, we would ask for the ESAs to take this point into consideration. In addition, we would like to have more clarification regarding the notion of "plain vanilla" derivatives mentioned in the methodologies list. Even if the industry has a general understanding, the corresponding law itself does not specify objectively which exact product falls into the plain vanilla category and which does not. For example, it is not clear to distinguish if an option on ETFs falls under the category of plain vanilla equity options or if equity total return futures fall under the category of single stock futures. We would appreciate some clarity on that point as well.

VI. Derivatives should not be looked at as causing potential greenwashing but in a comprehensive manner, including the contribution side: As expressed before, we strongly agree to include derivatives in the sustainable investment ratios. We advocate this position since derivatives can often contribute positively to sustainable investment, besides their potential negative contribution. However, the approach chosen by the ESAs is one-sided and focuses only on the negative contribution of derivatives due to the ESAs' greenwashing concerns. The ESAs seem to insinuate greenwashing risks are caused by derivatives only, which results in the proposal of including derivatives in PAI ratios. To us, this is a false and misleading starting point. This motivation might cause continuing misunderstandings with regard to derivatives right from the onset in future greenwashing discussions under the SFDR/Taxonomy framework. If the motivation is to solve the greenwashing issue in the entire sustainable finance framework, the discussion should encompass a more comprehensive approach and should not lead to the misrepresentation of a certain asset class. Overall, we advocate that the ESAs should broaden their perspective also in the direction of derivatives' positive contribution to sustainable investments, not only of potential greenwashing risks they could cause. In this way, the general asymmetry problem with derivatives' inclusion into the sustainable investment ratios occurring due to a one-sided representation towards negatively contributing derivatives in this consultation could be solved.

VII. It is misleading to include derivatives with any kind of underlyings into PAI calculations: The PAI calculations include "any derivative" (consultation document page 16, item 34) which seems rather misleading. The predominant reason is that some underlying asset classes are not included in the Taxonomy and SFDR scope since they are considered Taxonomy-neutral, such as interest rates, commodities, and foreign exchange. There might be limited or no KPIs identified for these asset classes by market players. Hence, it is questionable to include those derivatives in PAI ratios since they are not considered in any other sustainable ratios currently. A clarification and harmonization of scope are recommended.

VIII. "All" derivatives should be included in PAI ratios, not only the physically-delivered ones: In the current proposal by the ESAs, for those derivative exposures which do not ultimately result in a physical investment in the underlying security by the counterparty – or any other intermediary in the investment chain – the FMP would be

allowed to consider that a derivative investment does not result in an adverse impact and should therefore be allowed to exclude it from the numerator (consultation document page 16, item 34). However, this approach should be reconsidered by the ESAs, first of all for harmonization reasons, since there is no similar approach described for any other sustainable investment ratios. Secondly, the argument that including all derivatives, not only physically delivered ones, would be less limiting given the type of derivatives they are using currently. Based on the derivatives' mechanism when deploying strategies and the purpose of their use, they contribute to sustainable investments i.e., the proceeds received from a cash derivatives transaction might in turn be used to invest in green companies.

In our view, physical ownership is not a necessary criterion and/or evidence to demonstrate sustainable impacts. Therefore, its inclusion or exclusion should not be a condition for the calculation of ESG indicators such as PAI, Taxonomy-alignment or Sustainable Investment. Furthermore, derivatives help to share corporates' business risk and modify the cost of capital (via changing the amount of capital available at a given cost). Whether cash or physically settled derivatives are used, they are optimising the cost of capital of firms which is equally important. Without enough capital investors would not be able to make sustainable investments. Ultimately, effectively using derivatives allows to efficiently allocate capital, this holds true for general investments, but also in particular for sustainable investments.

Q15 What are your views with regard to the treatment of derivatives in general (Taxonomy-alignment, share of sustainable investments and PAI calculations)? Should the netting provision of Article 17(1)(g) be applied to sustainable investment calculations?

First of all, similarly to Q14, we would like to repeat that we welcome the ESAs' initiative to address the treatment of derivatives in sustainable finance. Until now, the understanding of whether derivative instruments contribute to the sustainable objectives of investors seemed disregarded. We consider this consultation a step in the right direction, after various consultations, discussions among market participants and the comprehensive work of experts in the ad-hoc platform of sustainable finance for Taxonomy regulation to envisage a comprehensive and proportionate approach for the inclusion of derivatives into the sustainable investment framework.

From our perspective, the consultation forms a good starting point by addressing the issue with the inclusion of derivatives into sustainable ratios but, there seems to be an underlying misleading bias towards derivatives in general addressing PAI ratios vs. Taxonomy-alignment ratios and sustainable investment ratios. The proposed initiatives in this consultation do not treat negatively and positively contributing derivatives in sustainable investments equally and fairly across different sustainable investment ratios. To us, this is a prior problem to be solved before delving into the netting and conversion methodology discussions. ESAs' one-sided consideration of negatively contributing derivatives into sustainability, PAIs, seems disconnected from all the past work done by the industry, i.e., ad hoc sustainable finance platform group, to show how derivatives positively contribute to and facilitate the sustainability and green transition.

We would like to remind that having an increase in the level of sustainable investments and a decrease in adverse impacts of investments on the environment is the ultimate goal and all financial instruments without exception have the potential to serve this goal. In that sense, sustainable investment ratios cannot be treated separately. More specifically, PAI ratios, Taxonomy-alignment ratios, and shares of sustainable investment should be considered as different sides of the same coin. It is difficult for us to see the logic behind the way they are treated as if they are disconnected. In our view, this fundamental point is missing in the overall sustainable finance framework and creates an artificial gap

between negatively and positively contributing derivatives into sustainable investment ratios.

When we zoom into the chosen approach by ESAs for Taxonomy-alignment ratios and shares of sustainable investments, we see certain shortcomings. Derivative exposures are not treated as instruments contributing to sustainable investments if they amount to an equivalent long net exposure and it is deemed that they are being used only to inflate Taxonomy-alignment and/or sustainability ratios artificially. Contrarily, net short positions of derivatives are considered in Taxonomy and sustainable investment ratios to reduce the long net exposure on a given Taxonomy-alignment / SFDR sustainable investment issuer. This is an unfair approach as if derivatives in these ratios can only ever have negative ESG impacts but not positive ones. As discussed in Q14, further intelligence gathering on the netting approach for any derivatives, not only for PAIs or Taxonomy alignment ratios is required. As put forward in Q14, including only net long positions or both net long or short positions of derivatives into the numerators of sustainable investment ratios should be further scrutinised and exemplified. Once, a conclusion is reached, ideally the same approach should be reflected both on PAIs, Taxonomy-alignment ratios and sustainable investment ratios for harmonization and equal treatment. Thus, the current artificial gap created between the approaches taken towards the negatively and positively contributing derivatives could be closed.

Lastly, we would like to highlight that the conversion methodologies proposed to translate derivatives into equivalent underlyings in PAI calculations are considered as an adequate starting point to be applied to Taxonomy-alignment and sustainable investment ratios. This would provide the same flexibility also for Taxonomy-alignment and sustainable investment ratios. Importantly, first, the netting methodology shall be identified, and once this has been established, we would support the proposal by the ESAs to use the conversion methodologies under AIFMD for all derivatives in sustainable ratios in general. However, we would also strongly recommend augmenting them with risk-based methodologies described in Q14, such as the delta and DV01 approaches.

All in all, our general opinion regarding the treatment of derivatives is that an alignment in the netting and conversion methodologies for all sustainable investment ratios would be imperative to reflect both sides of the coin appropriately. Currently, we see an asymmetric approach. We understand the ESAs' potential greenwashing concerns behind the initiatives but, to see the full and most realistic reflection of derivative exposures in all sustainable investment ratios and to find a balance in a meaningful direction, the best possible approach(es) should be seized. Only if this kind of harmonization is done, can derivatives be treated in the sustainable finance framework in a holistic manner. We would like to raise awareness that the adverse facet is only one side of the coin and that the ESAs should similarly expand also to review the treatment of derivatives in the scope of frameworks towards positive contributions in sustainable finance such as GAR/GIR in the Taxonomy scope. We would urge the ESAs to not only take initiative in the narrow scope of PAI, but to address the topic holistically. Addressing the subject only with regards to greenwashing and PAI overlooks other functions/purposes of derivatives, which are key objectives such as contributing to sustainability and lowering greenwashing risks.

Q16 Do you see the need to extend the scope of the provisions of point g of paragraph 1 of Article 17 of the SFDR Delegated Regulation to asset classes other than equity and sovereign exposures?

As mentioned in our responses to Q14 and Q15, we see both benefits and shortcomings of including net short positions into the numerators of sustainable investment ratios, and we see merit to scrutinise and finalise the decision with industry players based on their purposes on to use of derivatives. Provisions of point g of paragraph 1 of Article 17 of the SFDR Delegated Regulation are cross-referencing the Short-Selling Regulation ((EU)

236/2012) where netting methodologies for short positions are laid out. Before deciding on the appropriate legal cross-references to the Short Selling Regulation, we propose to first focus on deciding on the final netting methodology once more details have been clarified. Once it has crystallised which direction to take on netting, it then makes sense to refer to the appropriate laws and regulations.

Other adjustments

Q38 Do you see the need to set out specific rules on the calculation of the proportion of sustainable investments of financial products? Please elaborate.

For derivative instruments, we do not see the need to set out specific rules on the calculation of the proportion of sustainable investments. As we explained in detail in our responses to Q14 and Q15, we propose to use a single methodology applicable to derivatives in all sustainable investment ratios without exemption. After agreeing on the right netting approach, that approach can also be used for the calculation of the proportion of the sustainable investments of derivatives. The AIFMD-based conversion methodologies to translate these derivatives into equivalent underlyings and augmented by risk-based methodologies, as put forward in the response to Q14, could similarly also be used for these ratios. Different treatments in different ratios undermine the fair approach and holistic structure of the overarching sustainable investment framework.