

ESAs' joint consultation on the review of SFDR's Delegated Regulation regarding PAI and financial product disclosures

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AMAFI's answer

Association française des marchés financiers (www.amafi.fr) is the trade association representing financial markets' participants of the sell-side industry located in France. It has a wide and diverse membership of more than 170 global and local institutions notably investment firms, credit institutions, broker-dealers, exchanges and private banks. They operate in all market segments, such as equities, bonds and derivatives including commodities derivatives. AMAFI represents and supports its members at national, European and international levels, from the drafting of the legislation to its implementation. Through our work, we seek to promote a regulatory framework that enables the development of sound, efficient and competitive capital markets for the benefit of investors, businesses and the economy in general.

I. GENERAL COMMENTS

AMAFI welcomes the opportunity to answer the ESAs' joint consultation paper on the review of SFDR Delegated Regulation regarding principle adverse impacts (PAI) and financial product disclosures.

The association has been working for several months on the role derivatives can play in sustainable finance. In ([AMAFI/21-47](#)), we have tried to show that derivatives play an important role in the economy. Far from being remote from the real world or being vain trading instruments, they are an essential tool for economic agents to hedge their risks and facilitate their financing, contributing to the development of companies, including with regards to sustainability transformation.

We also had the opportunity to provide comments on this matter to the European Union Platform on Sustainable Finance (PSF) in relation to its work on how to account for derivatives in the Taxonomy.

More recently, we took part in consultations that raised questions on derivatives such as ESMA's guidelines' consultation on funds' names ([AMAFI / 22-13](#)) or the ESAs' call for evidence on better understanding greenwashing ([AMAFI / 23-03](#)) to provide our analysis and insights on derivatives and the role they play in sustainability.

As such, we are grateful to the ESAs that they are raising questions related to the consideration of derivatives through their consultation paper.

AMAFI would like to stress the importance of a consistent treatment of derivatives in the sustainable finance regulation, which is currently not the case. Work needs to be done to agree both on the role of derivatives in sustainable finance and on the calculation method to account for them. The proposed approach in the present consultation paper shows a paradox in that it considers the exposure provided by derivatives only when "harmful" and not when contributing to sustainability. Such approach should be discussed thoroughly, as it seems influenced by prejudices towards these financial instruments without demonstrated foundation. There is a need to develop a single methodology for the consistent inclusion of derivatives in the various

sustainable finance regulation (SFDR, Taxonomy, MiFID II), building on the PSF's work¹, the ESA's previous consultations and in coordination with the European Commission and the industry stakeholders. This should be done while taking into account the different challenges at stake, especially the need to consider all angles of contribution to sustainability (i.e. exposure as well as cash proceeds), and not the sole consideration of the risk of greenwashing.

Consistent with the focus of AMAFI's work on derivatives, we will focus on questions 14 and 15 of this joint consultation paper.

II. ANSWERS TO THE QUESTIONS

Question 14: Do you agree with the proposed treatment of derivatives in the PAI indicators or would you suggest any other method?

Exposure provided by derivatives

It is proposed to include “*any derivative with an equivalent long net exposure in the numerator of the PAI indicator, because in such cases the transaction would have resulted in money going towards the adverse impacts identified in the indicators*”, with the possibility to exclude it where it can be shown that it “*does not ultimately result in a physical investment in the underlying security by the counterparty*”.

AMAFI agrees that derivatives should also be considered as investment decisions and that indeed when they provide exposure to an asset with an adverse impact, they should be included in the calculation of the corresponding PAI indicator(s). The possibility to exclude them where it “*does not ultimately result in a physical investment in the underlying security by the counterparty*” is not relevant to us: the critical factor is not the ownership of a physical asset but the resulting overall exposure. The way to account for derivatives should be the same all along the chain of stakeholders (see example in the box below): the counterparty's hedging is irrelevant to represent the investor's own exposure to the asset.

Such logic of considering the ability of a derivative to provide exposure to an asset should however be applied in all situations, i.e. not only in those where the exposure is to an asset with adverse impacts but also in those where exposure to sustainable assets is achieved (see Question 15). There should be consistency across the three ratios in this respect. This consistency should also be effective with regards to the inclusion of both short and long positions in the three ratios.

Methodology to calculate the “equivalent net exposure”

As for the methodology to calculate the equivalent net exposure provided by a derivative to an asset, it should be clearly defined, so as to ensure consistency across the various pieces of regulation where such calculation is needed (Taxonomy, SFDR, MIF II ESG preferences, future ESMA's position on fund names). The revision of SFDR RTS is unlikely to be the right vehicle to clearly define such methodology, as it focuses on greenwashing risks and it does not consider the other pieces of regulation and the work done / still ongoing by the PSF². It seems necessary to adopt a transversal approach on this subject to amend consistently all the provisions needed in the various pieces of regulation.

¹ [Platform on Sustainable Finance's recommendations on data and usability of the EU taxonomy \(europa.eu\)](#)

² The European Union Platform on Sustainable Finance (PSF) published its Report on Data and Usability of the EU Taxonomy on October 11th, 2022 ([Platform on Sustainable Finance's recommendations on data and usability of the EU taxonomy](#)). This report, which provides recommendations to the European Commission, includes a section on the consideration of derivatives in the Green asset ratio (GAR) whose publication is required from financial institutions by the EU Taxonomy. The PSF's working group was however “*unable to reach a consensus on the way forward for derivatives within Taxonomy reporting and as such, recommends the European Commission mandate further work to the Platform 2.0 to research the consequences of the*” favoured approaches. More specifically, the PSF recommends that derivative instruments ought to be further examined until the 2024 review period.

AMAFI has been working on proposing a computation for those derivatives whose underlying can be easily assessed from a Taxonomy viewpoint, with a focus on derivatives with an equity or a corporate bond underlying (this focus does not preclude that derivatives based on other types of underlyings may also contribute to sustainability but further work is needed).

We believe that, for those derivatives, using the delta is the best method to calculate the exposure to the underlying shares or corporate bonds. The delta represents the amount by which the derivative’s value increases or decreases for a given change in the price of the underlying. All financial institutions (such as banks, investment firms, asset managers and insurers) use derivatives to compute the delta of their derivative positions on a daily basis for risk management purpose.

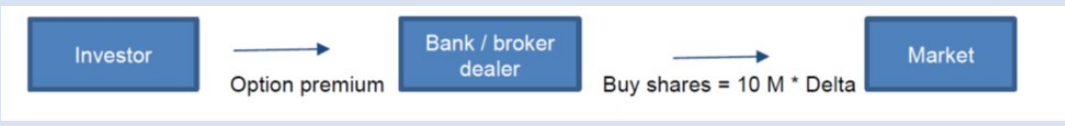
The net exposure (calculated as the full algebraic sum of the delta positions, both positive and negative) is what ultimately needs to be considered, as it reflects the risk taken or offloaded on the assets, which shows the commitment (negative or positive) of the holder of the position to the corresponding companies. This measure of the exposure provided by derivatives is the one considered by the PSF and is already used in EU legislation, although in different contexts, such as for the purposes of calculating the net short position in shares in the Short Selling Regulation, already referenced in the present consultation: in this regard, the Annex II, Part I of the [Commission Delegated Regulation \(EU\) No 918/2012](#) should also be referenced, as it provides a method to consider derivatives: “Any derivative and cash position shall be accounted for on a delta-adjusted basis, with cash position having delta 1. To calculate the delta of a derivative, investors shall take into account the current implied volatility of the derivative and the closing price or last price of the underlying instrument. In order to calculate a net short position including equity or cash investments and derivatives, natural or legal persons shall calculate the individual delta-adjusted position of every derivative that is held in the portfolio, adding or subtracting all cash positions as appropriate.”.

For the sake of clarity, both positive and negative delta exposures need to be considered, as this is key to reflect the true picture of all positions held by the various stakeholders.

The example below illustrates that accounting for both long and short delta positions provides a true picture of the exposures across the whole chain of stakeholders.

Example

An investor, subject to the publication of the Green investment ratio and SFDR product Taxonomy ratio, purchases a call option on the shares of the company Windturbine for a nominal of 10M euros.



	Investor	Bank / broker dealer	Seller of the share in the market
Economic exposure to the shares	10 M x Delta	Zero (as the bank/broker dealer is delta hedged)	-10 M x Delta
Taxonomy exposure	10 M x Delta x Taxonomy alignment ratio of the company (this contributes to the GIR)	Zero (as the bank/broker dealer is delta hedged)	- 10 M x Delta x Taxonomy alignment ratio of the company

The above long call position results in the investor having a Taxonomy exposure, and the seller of the shares having the opposite Taxonomy exposure. Therefore, when both long and

short delta exposures are considered, no actor in the trading chain can report more than what it truly holds, and the holder of the derivative takes all the credit associated with taking the corporate business risk.

Method to perform netting

Regarding the method FMPs should use to perform netting, it is suggested that *“In accordance with Q&A 3.1 of the November 2022 Q&As, adverse impacts should be netted at the level of an individual counterpart without going below zero”*. The said Q&A provides that *“The calculations for short positions should apply the methodology used to calculate net short positions laid down in Article 3(4) and (5) of Regulation (EU) No 236/2012³ of the European Parliament and of the Council. The principal adverse impacts of long and short positions should also be netted accordingly at the level of the individual counterpart (investee undertaking, sovereign, supranational, real estate asset), but without going below zero”*.

AMAFI agrees that such methodology could be used but does not agree with the proposal to discard altogether net negative exposures, as these are the reflection of a disengagement from the asset with principal adverse impacts, reflecting the undesirability of the asset, hence putting pressure on its valuation and overall desirability to investors. In our view, a net short exposure to an asset with a principal adverse impact should thus not be discarded, otherwise providing a partial picture of the exposure to the asset, which is inconsistent with SFDR’s core objective of accurate disclosure. The way to depict such net short exposure would however need to be defined.

Question 15: 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?

Long net exposure on a given issuer

As mentioned before, it is very important to have a consistent approach towards derivatives among the various ratios more specifically, and in sustainable finance regulations more generally, to clarify how derivatives can be considered both for the positive and negative exposures they provide.

The table proposed in the consultation is illustrative of the current inconsistencies in dealing with derivatives between the Taxonomy regulation and SFDR. Inconsistencies of two kinds show in the table:

- Like in question 14., there is an explicit recognition that derivatives do provide exposure to assets. However, only when this exposure is detrimental to sustainable investment it is considered (short positions for Taxonomy-alignment and share of sustainable investments and long ones for PAI calculations). In other words, the exposure that derivatives can provide to assets is discarded when those are sustainable or Taxonomy-aligned. The role of derivatives is recognized only when it has a negative impact, but not when it has a positive one, which is not consistent. This calls for a general position on the role of derivatives, not just in relation to the SFDR RTS (see below *“how derivatives can contribute to sustainability”*).

³ *“4. For the purposes of this Regulation, the position remaining after deducting any long position that a natural or legal person holds in relation to the issued share capital from any short position that that natural or legal person holds in relation to that capital shall be considered a net short position in relation to the issued share capital of the company concerned.*

5. For the purposes of this Regulation, the position remaining after deducting any long position that a natural or legal person holds in relation to issued sovereign debt and any long position in debt instruments of a sovereign issuer the pricing of which is highly correlated to the pricing of the given sovereign debt from any short position that that natural or legal person holds in relation to the same sovereign debt shall be considered a net short position in relation to the issued sovereign debt of the sovereign issuer concerned” (Regulation (EU) No 236/2012, Article 3(4) and (5)).

- Recital (33) of SFDR RD states that “*Due to the lack of reliable methodologies to determine to what extent exposures achieved through derivatives are exposures to environmentally sustainable economic activities, such exposures should not be included in the numerator*”. The table (first column) concludes that short positions achieved through derivatives should be included, while still not including the long ones. Such conclusion lacks legal basis as it is not consistent with recital (33) which does not distinguish between short and long exposures. This adds to the inconsistency described in the paragraph above.

Both the amount of exposure achieved by long and short positions ought to be reflected for their full value so as to represent the entire economic exposure. AMAFI hence does not agree with the proposed treatment as it sees an asymmetry in the consideration of derivatives that conveys a biased representation of the true exposure achieved through these financial instruments.

The approach for taking derivatives into account needs to make sense for all three ratios this consultation paper deals with. This means that long positions and short positions should unequivocally be taken into account and netted in the numerator of these ratios to avoid any inconsistency.

Method to calculate net positions

AMAFI agrees with using the **method to calculate net positions** prescribed by the Short Selling Regulation. The long and short positions considered to obtain the net position should however include all the exposures provided by derivatives, both positive and negative. All impacts must be included to obtain a truthful value of the contribution (negative or positive) to sustainable assets.

With regards to **applying such method to other asset classes**, AMAFI considers, that in line with the PSF’s work and our own previous work, the asset classes to be considered are shares and corporate bonds.

Net short exposure in a given issuer

Regarding net short exposure on a given issuer (last line of the Table), as explained in Question 14, AMAFI considers that a negative exposure to an issuer can be useful information when it is the reflection of a disengagement from an issuer with activities having principal adverse impacts.

How derivatives can contribute to sustainability in the context of SFDR

The role of derivatives as financial instruments used in an SFDR product needs to be considered fully. As derivatives do not directly provide financing to the underlying company, their contribution to sustainability is often questioned. It should be noted however that the absence of such direct financing is not specific to derivatives. It is indeed the case of all secondary market investments where investors exchange with each other rather than with the issuing entity, i.e. without directing new capital to the company.

As referred to by the FCA in a consultation paper⁴, there are three ways to influence corporate behavior for a positive outcome to sustainability: bringing new financing (e.g. loans and primary markets), exercising stewardship through voting & engaging, and influencing the cost of capital.

Derivatives through the negative or positive economic exposure help investors achieve (for e.g. on the shares of a company) impact demand on these shares on the secondary markets, contributing to their liquidity and price formation⁵. The liquidity of the securities and their valuation on the secondary markets

⁴ See in this respect, [FCA's consultation CP22/20, section 4.10, Box 3](#), which describes the three main channels or mechanisms by which an investor may plausibly contribute to positive outcomes for the environment and/or society.

⁵ We can refer to the Schiller - Fama debate (one “Nobel” price against the other) on the quantification of a trade’s price impact: if we side with Schiller, when an investor decides to grow the ranks of those willing to hold an exposure on a stock up to a certain price, it will result in a change in the price (persistently higher new price if that investment decision is a buy, lower if it is a sell) even in the absence of any fundamental news changing the “fundamental” valuation of the stock. Work on the quantification of this impact has been carried out, for e.g. by Bouchaud

are critical factors for investors in the primary market to consider purchasing a security. Derivatives hence play an integral part in the setting of the cost of capital of companies, i.e. the cost at which they are able to raise financing on markets. This is particularly meaningful with regards to sustainability where investors' appetite or lack of appetite for a company is likely to be gradually reflected in its valuation and cost of capital as the impact of climate change increases.

The impact of derivatives on the cost of capital can be illustrated as shown below.

Contribution of derivatives to the cost of equity of listed companies



Denying such impact of derivatives would likely lead to a reduction in the use of derivatives by investors to favor cash investments. This would deprive them from the benefits of derivatives in facilitating exposure to companies, tailoring it with their risk appetite, and in providing wider access to markets and investment opportunities. As for retail clients with ESG objectives, it would make the offering of structured products to them more difficult, even though these products enable them to participate to the equity market while benefiting from an amount of capital protection.



(<https://arxiv.org/pdf/2108.00242.pdf>) for idiosyncratic stocks (what happens to a stock price when more buying of it happens) or Gabaix and Koijen (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3686935) for more macro impact (what happens to prices when we inject new cash into the market).