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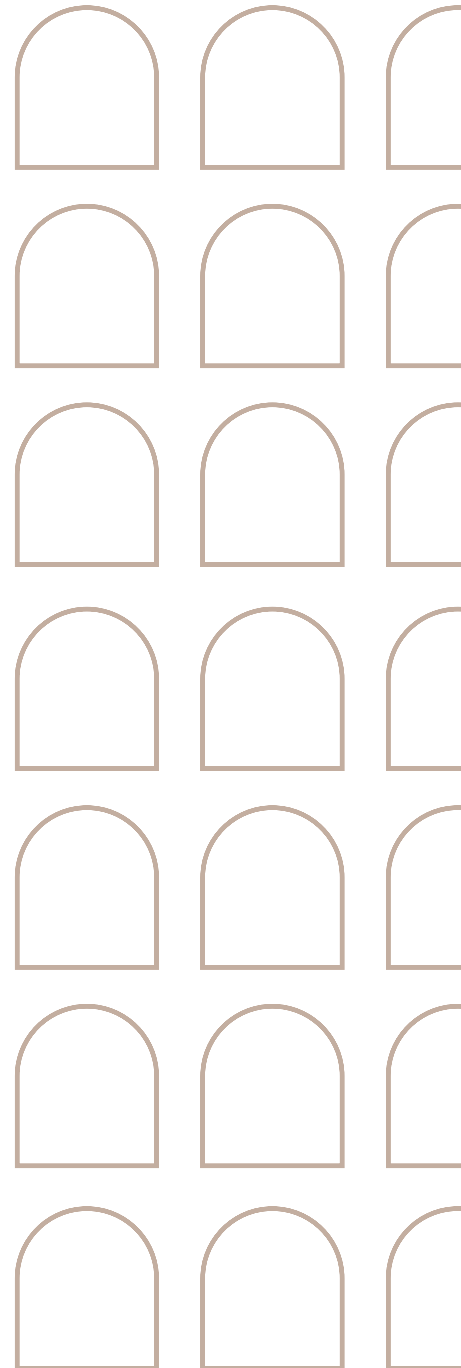

STG Policy Papers

POLICY BRIEF

CAN THE NEW EUROPEAN SUSTAINABLE FINANCE RULES IMPROVE THE INTEGRITY OF VOLUNTARY CARBON MARKETS?

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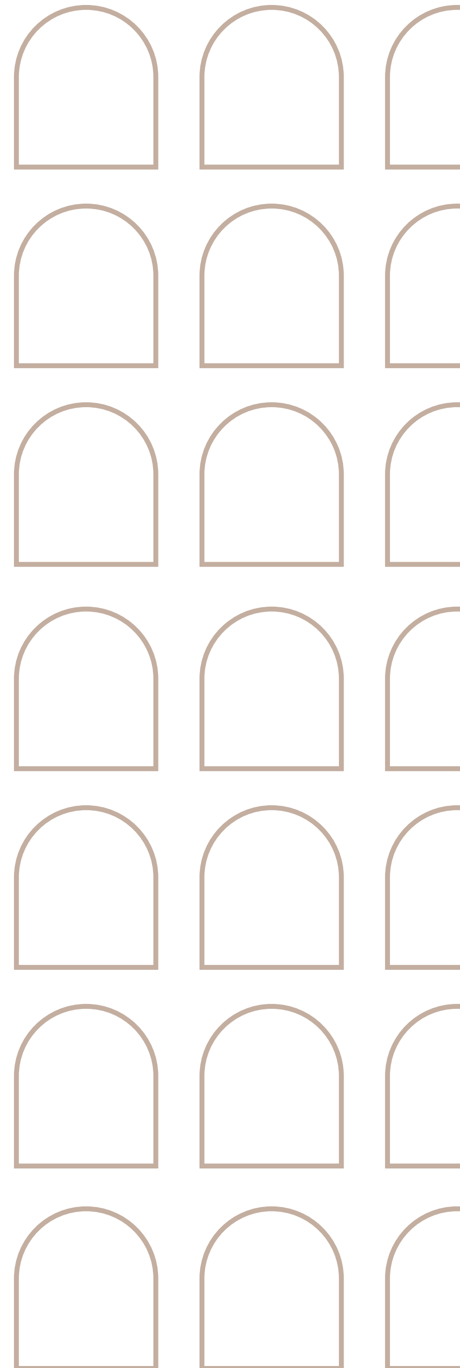
EXECUTIVE SUMMARY

In this Policy Brief we assess how new and pending EU legislation on sustainability reporting and disclosure can improve the integrity of voluntary carbon markets. Corporations use voluntary carbon credits to support their net zero strategies. Over a fifth of the 2000 largest public companies have now committed to net zero[1]. The demand for carbon credits is growing with the number of these commitments[2]. However, the integrity of these voluntary carbon credits remains questionable in the absence of clear rules on the monitoring, verification and reporting of the carbon emissions reduction or removal at the origin of the credits for Core Carbon Principles and an Assessment Framework[3]. Under the slogan "build integrity and scale will follow", the Integrity Council of the Voluntary Carbon Market has published a proposal, which focuses on the supply side of the market, i.e. the producers of carbon credits. In this Policy Brief, we focus on the demand side of the market: the corporations and financial market participants who buy these credits. We found that the European Commission proposal for the Corporate Sustainability Reporting Directive could establish the world's first explicit and legally binding reporting standard for the use of voluntary carbon credits by European companies. If both sets of rules are enacted, the voluntary carbon market would get a major transparency boost. Other jurisdictions could learn from this experience to establish their own rules. The EU itself can also learn from this proposal, as the earlier Sustainable Finance Disclosure Regulation did not provide the same clarity on how to disclose investment in voluntary carbon credits or in companies that hold them. We recommend some regulatory changes and additions in order to complete the demand-side regulation of voluntary carbon markets.



1 Taking stock: A global assessment of net zero targets | Energy & Climate Intelligence Unit (eciu.net)
2 Ecosystem Marketplace, State of the Voluntary Carbon Markets 2021
3 Public Consultation - ICVCM

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Views expressed in this publication reflect the opinion of individual authors and not those of the European University Institute.

1. VOLUNTARY CARBON MARKETS ARE ATTRACTING A LOT OF INTEREST, BUT CREDIBILITY REMAINS LOW

At COP26 parties made some unprecedented decisions surrounding the issue of international carbon market mechanisms. It is recognised that voluntary markets can enable financing for carbon reduction and/or offsetting projects around the globe. However, uncertainties about the credibility of these credits and the carbon claims they represent persist. In a previous Policy Brief[4], we discussed the conditions that need to be fulfilled for voluntary carbon markets to be a credible instrument to achieve net zero, namely:

1. Full transparency on the baseline and stringency in assessing additionality claims;
2. Clear distinction between reduction and removal credits;
3. Tight rules on credit eligibility, liability, permanence, etc.;
4. No double-counting of emission reductions under the Paris Agreement;
5. Restrictions on pre-existing 'legacy' credits, particularly those of low environmental integrity.

To be credible, a voluntary carbon credit must reduce the emission of a ton of carbon or remove a ton of carbon from the atmosphere. Every step in the production of such a credit must be verifiable. This requires rules on transparency and reporting, which is exactly the objective of the new European Sustainable Finance Disclosure Rules (SFDR) and the draft Corporate Sustainability Reporting Directive (CSRD):

- The Sustainable Finance Disclosure Regulation (SFDR)[5] obliges financial market participants to be transparent about the sustainability risks of their investments. It requires investments marketed as 'sustainable' to prove alignment with the European Taxonomy in the pre-contractual documentation and annual reporting[6]. These requirements are applicable to all funds sold in the EU market (whether the investments are located within or outside the EU[7]. The Regulation came into force on 10 March 2021. Regulatory Technical Standards, elaborated by the European Supervisory Authorities, have been published for entry into force on 1 January 2023.
- The Commission proposal for Corporate Sustainability Reporting Directive (CSRD)[8], published by the European Commission on 21 April 2021, has been voted in the European Parliament and is currently under discussion in the Council of the EU. The CSRD when adopted, would oblige all corporates, not only those active in the financial sector, to report on sustainability risks and opportunities, and for these reports to be independently audited.

These regulations have the potential to establish much greater transparency on the integrity of voluntary carbon credits used by financial entities and corporates to support their net zero claims. In this Paper, we assess the extent to which the (draft) legal texts meet this expectation.

To test the adequacy of the SFDR and the CSDR, we consider three type-cases:

1. A non-financial corporation using carbon credits to back up its net zero claim, to be reported under CSRD.
2. A financial market participant investing in companies that use voluntary carbon credits to back up its Paris-aligned trajectory or net zero claim under SFDR.
3. A financial market participant investing directly in carbon credits as an asset under

4 Cornillie, J., Delbeke J., Runge-Metzger, A., Vis, P., Watt, R., What future for voluntary carbon markets?, STG Policy Briefs 2021/08

5 Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector

6 The SFDR requires financial market participants to report on the Principal Adverse Impacts of their investments and to explain whether their products promote environmental or social characteristics (art 8, so-called 'light green' funds) or have sustainability as an objective (art.9, so-called 'dark green' funds).

7 The European Banking Authority (EBA), The European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pension Authority (EIOPA)

8 Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting, COM/2021/189 final.

SFDR.

Assessment of these rules yields insights into the opportunities and limits of regulation of voluntary carbon markets and suggests the need for further regulation.

2. CARBON CREDIT AS CORPORATE SUSTAINABILITY INSTRUMENT UNDER CSRD RULES

A first case to assess is the disclosure obligations for a non-financial company that supports its net zero claim with voluntary carbon credits. The pre-amble, the Directive itself and the draft Sustainability Reporting Standard in implementation of the proposal for the Corporate Sustainability Reporting Directive contain new developments in that regard.

First, the pre-amble of the Directive explicitly refers to the matter of offsets:

"With regard to climate-related information, users are interested in knowing about undertakings' physical and transition risks, and about their resilience to different climate scenarios. ***They are also interested in the level and scope of greenhouse gas emissions and removals attributed to the undertaking, including the extent to which the undertaking uses offsets and the source of those offsets.*** *Achieving a climate neutral economy requires the alignment of greenhouse gas accounting and offset standards.* ***Users need reliable information regarding offsets that addresses concerns regarding possible double-counting and overestimations, given the risks to the achievement of climate-related targets that double-counting and overestimations can create.*** *The reporting standards should therefore specify the information undertakings should report about those matters."*

The Directive itself contains the general obligations on corporate sustainability reporting. The new Article 29a specifies how the corporate group will need to provide information on the strategy, targets, policies, actions, risks, and indicators regarding sustainability. When applied to carbon credits and offsets, these general rules would require the undertaking to report on changes in the sustainability risk of the credits on the balance sheet. Furthermore, the sustainability reporting standards and assurance of sustainability reporting that will be further developed by more technical secondary legislation, also create the opportunity for setting specific standards on voluntary carbon credits. To that effect, draft European Sustainability Reporting Standards (ESRS) are being developed by the European Financial Reporting Advisory Group, an advisory body to the European Commission.

The draft Sustainability Reporting Standards on Climate[9] contains the first explicit standards on the use of voluntary carbon credits by corporations. Disclosure requirement E1-13 of the Exposure Draft deals with 'GHG mitigation projects financed through carbon credits'. The standard is worth quoting here, as it is the first of its kind (bold emphasis is authors own):

"56. The undertaking shall disclose the amount of GHG emission ***reductions or removals*** *from climate change mitigation projects outside its value chain it has financed through the purchase of carbon credits.*

57. The principle to be followed under this Disclosure Requirement is to provide an understanding of ***the extent and quality of carbon credits*** *the undertaking has purchased from the voluntary market and cancelled in the reporting period.*

58. The disclosure required by paragraph 56 shall include: (a) the total amount of carbon credits in metric tons of CO2eq that are ***verified against recognised national or international quality standards*** *and cancelled in the reporting period, broken down by: i. the share (in % of volume) of reduction projects and removal projects; ii. the share (in % of volume) for each recognised quality standard; iii. the share (in % of volume)* ***issued from projects in the European Union;*** *and iv. if applicable, the share (in % of volume) that* ***qualifies as corresponding adjustments under Art. 6 of the Paris Agreement;*** *and (b) the total* ***amount***

9 EFRAG (2022), ESRS E1: Climate change, Exposure Draft, April 2022

of carbon credits in metric tons of CO2eq *planned to be cancelled in the future, based on existing contractual agreements."*

Several factors in these standards address key elements of the voluntary carbon credit integrity debate by proposing:

- GHG emission reduction or removal through the purchase of carbon credits;
- The extent and quality of credits;
- Verification against recognised quality standards;
- Origin of the credits (EU/non-EU);
- Qualification under Article 6 of the Paris Agreement;
- Planned cancellations of credits in the future under existing contractual arrangement.

One element that is absent from this reporting standard is the disclosure of the specific projects from which quantities of credits are purchased. The draft Standard relies on the verifier to explain the integrity of the credit. The question then become how the verifier is being verified. These are the rules that Integrity Council for the Voluntary Carbon Markets is developing. If those rules are adequate, it indeed suffices here to mention the verification standard and further transparency on specific projects would not be needed. If not, additional reporting on the underlying projects will be required.

In conclusion, this first sustainability reporting standard requires most relevant information to be disclosed. In so doing, it provides a first demand-side rule to match the above-mentioned Integrity Council's supply-side quality rules. Once both set of rules are adopted, the EU will have put in place the regulations needed to support the integrity of the voluntary carbon market.

3. CARBON CREDIT AS SUSTAINABLE INVESTMENT UNDER SFDR RULES

Now we turn to the SFDR, which is applicable to all financial market participants who offer financial products in the EU. We deal with the case of a financial market participant, such as a fund manager, who invests in companies that uses voluntary carbon credits to support its net zero or Paris-alignment claim.

Under the SFDR, the financial market participant will have to comply with the general obligations on transparency on the so-called 'principal adverse impacts' and the integration of sustainability risk in its decision-making and remuneration policies. The European Supervisory Authorities (ESAs) have developed Regulatory Technical Standards (RTS) to explain compliance with these dispositions, providing guidance with regards to the pre-contractual, website and periodic product disclosure requirements. In general, financial market participants need to provide information 'easily accessible, non-discriminatory, free of charge, prominent, simple, concise, comprehensible, fair, clear and not misleading' (Article 2(1)). The templates in Annex III (pre-contractual disclosure of sustainable investment) and IV (periodic reporting) of the RTS prescribe in detail how the information must be made available.

Many of these elements are relevant for assessing the integrity of financial products that consist of investment in companies that hold voluntary carbon credits:

- The general obligation to provide 'non-misleading' information provides a basis for screening of emission reduction or removal claims. Funds providing false claims about the net zero trajectory of the companies invested in risk being caught by financial regulators and could face fines.
- If a financial product with a stated objective of reducing carbon emissions ultimately relies on voluntary carbon credits to achieve this reduction, it must make sure that these credits represent effective emission reductions. If not, it would make a false disclosure of an Article 9 product.
- The information on the asset allocation also needs to include a description on how the investment does no significant harm to other sustainable investment objectives and how it respects minimal environmental and social safeguards. So, if investment is

made in companies relying on voluntary carbon credits, it must be shown that these do no significant harm and comply with the standards and safeguards.

In theory, the SFDR obligations and RTS allow for transparency with regards to the carbon footprint. There is, however, a major caveat with respect to the use of carbon credits to demonstrate emission reduction, which would need to be clarified and made consistent between the SFRD and the CSRD.

Firstly, in Annex I of the RTS, the formula for carbon footprint takes into account scope 1, 2 and 3 emissions, but not removals.

'carbon footprint' shall be calculated in accordance with the following formula:

$$\frac{\sum_{n}^{i}\left(\frac{\textit{current value of investment}_i}{\textit{investee company's enterprise value}_i} \times \textit{investee company's Scope 1,2 and 3 GHG emissions}_i\right)}{\textit{current value of all investments (€M)}}$$

Based on this Annex, carbon credits would not count towards the demonstration of emission reduction. This is inconsistent with the draft sustainability reporting standards under the CSRD, which were published later. The issue should be clarified. Similarly, the EU Climate Transitions Benchmark Regulation 2019/2089, to which the SFDR refers, also focuses on the greenhouse gas emission reduction targets and achievements of the underlying assets. It also does not explicitly include the use of carbon credits to offset emissions. From this analysis it could be concluded that carbon credits do not count as emission reduction under the SFDR.

In our view, the Regulatory Technical Standards, implementing the SFRD, would benefit from the same clarity in addressing voluntary carbon credits as the draft Sustainability Reporting Standards. Concretely, we recommend that the formula for measuring the carbon footprint in Annex 1 of the RTS should be adjusted so that the value of the investee company's scope 1, 2 and 3 emissions also take into account reductions or removals from climate mitigation projects which it has financed through the purchase of carbon credits. Additionally, a specific RTS indicator dealing with carbon credits using the same disclosure requirements as the draft Sustainable Reporting Standard would be useful. Lastly, although the body of the SFDR does not exclude carbon credits and the general regulations are relevant for its use too, it might be useful to explicitly address this case in the preamble in the next revision, similar to the preamble of the CSRD.

4. DIRECT INVESTMENT IN CARBON CREDIT AS AN ASSET UNDER SFDR RULES

A last case to consider is financial market participants investing directly in carbon credits. Carbon credits have a certain market value at acquisition which might evolve over time, as a result of global supply and demand for these credits and the perceptions of the environmental integrity of the carbon credits. There is a financial risk and a sustainability risk attached to these credits. Does the underlying activity really reduce or remove emissions throughout the crediting period? And will the value of this emission reduction increase over time, under future carbon market rules? If the corporate and governmental net zero claims are credible, demand for carbon credits is expected to increase. If the carbon credits meet strong standards of integrity, the market value of carbon credits might also increase. Hence, both the market for and the value of these credits could be expected to grow. However, if market oversight fails, bad credits could drive out good credits, and the market could collapse, as has happened with CDM credits[10].

In the context of this Policy Brief, the question is which disclosure rule would be applicable for such a carbon credit fund? As with trading in other commodities, there are not many specific disclosure rules to take into consideration when investing in carbon credits. If the fund holds on to carbon credits as an asset, it will need to explain its fair value

10 See Ecosystem Marketplace, State of the Voluntary Carbon Markets 2021, Figure 1

under general accounting rules. But that is a market evaluation, not a sustainability one. Under the SFDR and the adjacent delegated regulations for insurance and reinsurance companies and alternative investment fund managers, and the products and services they offer, the financial market participant will need to explain how it integrates sustainability risks in general. The SFDR reporting rules will require an annual update on these risks. Moreover, the integration of sustainability factors has recently been added to the product governance regulations (i.e. those established by the markets in financial instruments Directive) in the sustainable finance package by the European Commission[11]. Carbon credits in a portfolio, or credits as part of a product, could be viewed as a particular sustainability risk, based on the probability that the ton of carbon covered by the carbon credit remains removed or that the carbon emission reduction has been truly additional. As time passes, events happen – such as the Californian forest fires[12] - and knowledge changes, hence the perceived sustainability value of the credits might also change. Hence, it would be useful if an annual update on the fair sustainability value of carbon credits was required for those investing in carbon credits.

There are currently no specific rules on how to report on these credits and how to value their integrity. The new rules on the integration of sustainability risks certainly push a financial market participant who wants to buy and sell credible carbon credits as a sustainable investment to be transparent about the sustainability risks attached to these credits. However, it remains unclear how these rules would substantially improve the integrity of the voluntary carbon market. As with the previous case under the SFRD, guidelines from the European Supervisory Authorities will be needed to specifically address this question. We recommend a specific RTS on direct investment in carbon credits, with the conditions under which it would be disclosed as Article 8 or 9 investments.

5. CONCLUSION

Whereas the proposal for the Corporate Sustainability Reporting Directive and the draft Sustainability Reporting Standards prepared for its implementation could establish the world's first explicit and legally binding reporting standard for the use of voluntary carbon credits by European companies, the earlier Sustainable Finance Disclosure Regulation did not provide the same clarity on how to disclose investment in voluntary carbon credits or in companies that hold them. Worse, the current set of Regulatory Technical Standards seems to exclude these credits altogether from the evaluation of the degree of sustainability of an investment. In its current form, the SFDR, and the RTS implementing it, still fall short of what is needed to promote high integrity voluntary carbon markets.

We recommend three regulatory changes. First, the carbon footprint of investing companies should include greenhouse gas emission reductions or removals from all climate change mitigation projects financed through the purchase of carbon credits, not only reductions and removals from its own value chain. For that, Annex I of the current RTS implementing the SFDR needs to be modified. Second, as the draft European Sustainability Reporting Standards implementing the CSRD does contain all the relevant reporting features, the European Supervisory Authorities could benefit from integrating these into their draft Regulatory Technical Standard as well. Such a well-defined Regulatory Technical Standard would lead to an annual update of the fair sustainability value of carbon credits under the general reporting rules. Third, a specific Regulatory Technical Standard should be issued to guide direct investment in carbon credits as a commodity.

11 COMMISSION DELEGATED REGULATION (EU) 2021/2139 of 4 June 2021 supplementing Regulation (EU) 2020/852 of the European Parliament and of the Council by establishing the technical screening criteria for determining the conditions under which an economic activity qualifies as contributing substantially to climate change mitigation or climate change adaptation and for determining whether that economic activity causes no significant harm to any of the other environmental objectivest

12 Wildfires destroy almost all forest carbon offsets in 100-year reserve, study says | Financial Times (ft.com)

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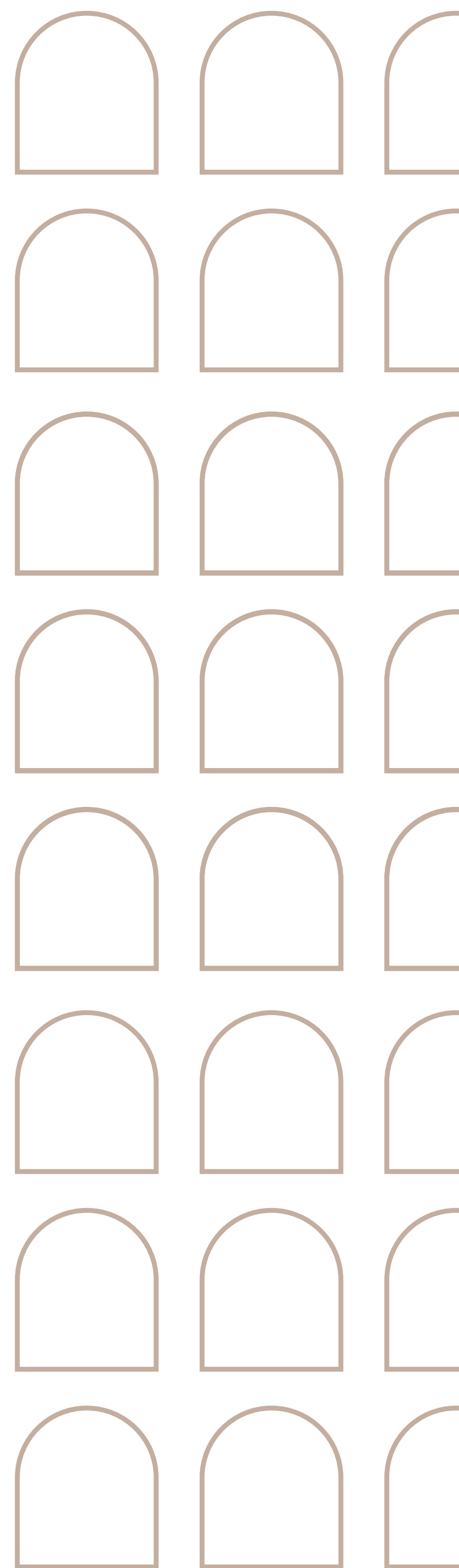

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