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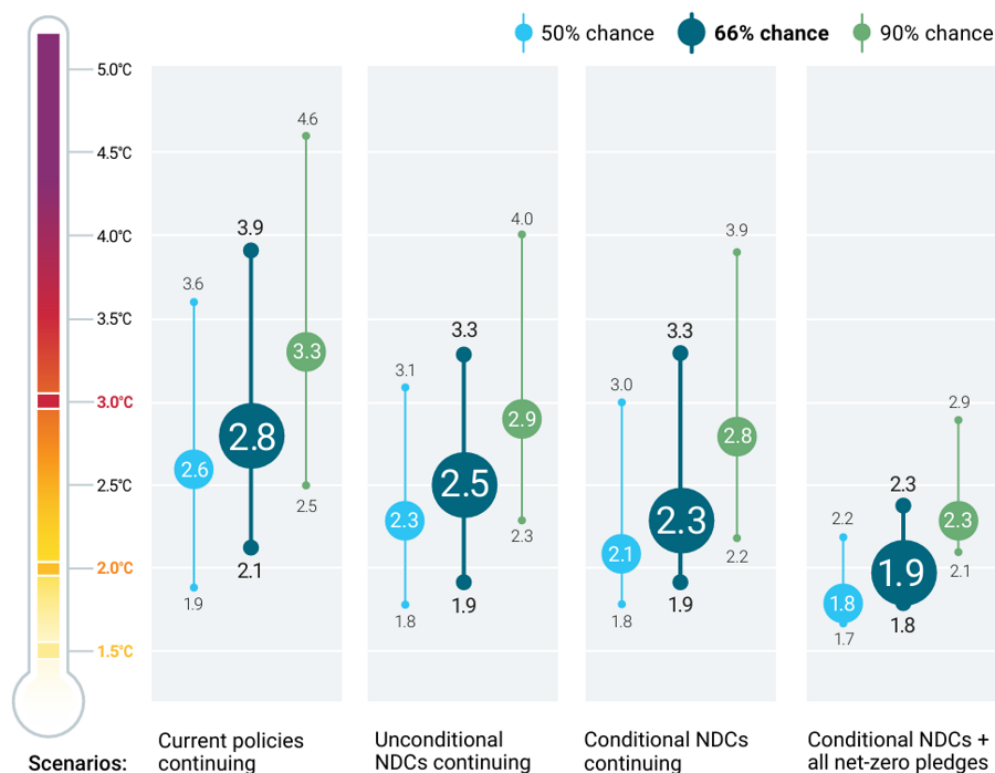
Sustainable Finance News Wrap-Up

- **In focus:** As COP30 in Belém, Brazil nears the end, climate mitigation efforts appear to be stalling when they need to accelerate – with the fossil fuel phase-out roadmap finally dropped in this morning’s draft of the deal. Progress on climate financing yet again holds the key to progress more broadly – highlighted by India withholding its updated climate pledge seemingly due to insufficient willingness of developed nations to shoulder the burden of financing. Similar discussions also shape the climate adaptation discussions – a key item on the COP30 agenda – with developing countries concerned that not enough support will be provided to help them prepare against a warming climate. Ultimately, the success of adaptation efforts and the broader climate agenda seem to increasingly hinge on resolving the persistent finance gap between developed and developing nations.
- **In briefs:**
 - AXA IM secures USD560mn for natural capital strategy.
 - EIB launches global Green Checker tool to boost sustainable financing.
 - The European Parliament backs new 2040 climate target.
 - Transition finance guidelines released by International Capital Markets Association.
 - Denmark scores highest in annual Climate Change Performance Index (CCPI) ranking for the fifth year in a row.
- **Sustainable products deep-dive:** Following leaks earlier this month, the European Commission announced its proposed update of the Sustainable Finance Disclosures Regulation (SFDR) yesterday. In a move that appears to address the criticisms against SFDR 1.0, namely that it was a cumbersome disclosure regime plagued by uncertainty over definitions, SFDR 2.0 introduces several key changes. Most prominent of which is the big step it takes towards formalizing its role as a categorization system through the introduction of three product categories, while seeking to strip away the elements that increased confusion, uncertainty and added significantly to administrative burdens. The SFDR update could further act as a catalyst to drive a broader adoption of labelled bonds, with EU Green Bonds set to particularly benefit.

In focus: Climate finance and adaptation in spotlight at COP30 as mitigation stalls

As COP30 draws towards a close after another seasonal round of intense climate negotiations in Belém, Brazil (November 10-21), it is becoming increasingly apparent that climate action is stalling when it should accelerate. According to UN Environment Programme's (UNEP) global "emissions gap" report, countries' national climate targets and plans (NDCs) puts the world on track for 2.3-2.5C warming compared to pre-industrial levels (see graph below). This follows a warming record of 1.55C over 2024. Add to this the US not sending a COP delegation this year and the EU just barely agreeing on a 2040 target in the eleventh hour – a target described by China's climate envoy Liu Zhenmin as "not so good". Global climate action faces headwinds.

Peak warming over the twenty-first century (°C) relative to pre-industrial levels - chance to limit warming within range



Source: UNEP

Climate finance discussions progress key to overcoming slowing mitigation efforts

While updated NDCs are a key item on the COP30 agenda, discussions on their financing take centre stage. In essence, climate finance can be considered at the heart of the 'Grand Bargain' of the Paris Agreement, namely that developing countries set more ambitious climate action plans if they receive financial support from developed countries.

To this end, COP29 in Baku last year was characterized by tough negotiations around a new target for climate finance (see our newsletter for November 2024). The outcome of a formal target of USD300bn per year by 2035 left many in the developing country grouping bitterly disappointed. Further, the resulting last minute call to mobilise 1.3 trillion per year by 2035 from “all actors” and “public and private sources” has been repeatedly criticized as merely an aspirational call to action. As such, ahead of COP30, the Brazilian Presidency launched the “Baku to Belém roadmap” to further elaborate how the 1.3 trillion could be mobilised.

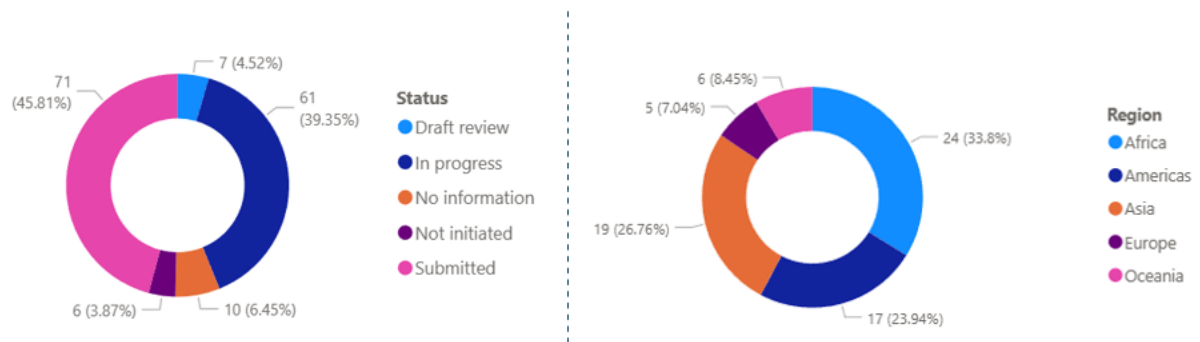
However, lack of progress on climate funding at COP30 seems to have had led India, the world’s most populous nation and the third largest emitter, to withhold submitting its climate pledge as of time of writing November 21st - the last day of COP30. Attempts to include a roadmap to phase-out fossil fuels in the COP30 agreement also appeared to be contingent on a breakthrough on the finance question, as well as convincing petrostates to not block it. As of Friday morning, however, the draft text for the COP30 agreement had dropped any mention of fossil fuels. Reportedly, about 80 of the nearly 200 nations attending COP were in support of the roadmap, but several delegates from the developing country grouping have emphasised the importance of climate finance to deliver the transition – be it phasing out fossil fuels or developing its alternatives.

All eyes on climate adaptation and its financing in Brazil

Climate adaptation is one of the main items on the agenda in Belém. Preparing for what inevitably appears to be rising global warming is fast coming onto the radar of countries, financial institutions and corporates alike. To date, climate finance discussions have typically focused on supporting efforts to reduce GHG emissions (climate mitigation) and less on helping countries to deal with climate change impacts (climate adaptation). The adverse effects of climate change hit unevenly, with developing countries often most vulnerable – making adaptation progress and financing of particular importance to bridging the gulf between developed and developing countries in the COP processes.

As an adaptation recap, the 2015 Paris Agreement established a Global Goal on Adaption (GGA) to strengthen countries’ resilience and reduce vulnerability. Eight years later, at COP28, negotiations began on defining indicators to measure this. Landing on a final consolidated set at COP30 – a full decade since Paris - is a key ambition of the conference. This would in turn help measure and operationalise adaptation efforts. The submissions of National Adaptation Plans – like NDCs but for adaptation – is another talking point of the conference. A total of 71 developing countries had as of time of writing submitted their NAP, but the Climate Convention (who organises the COPs) found in a report from October that the main difficulty of NAPs is their implementation.

Developing country NAPs by status (left) and submission by region (right)

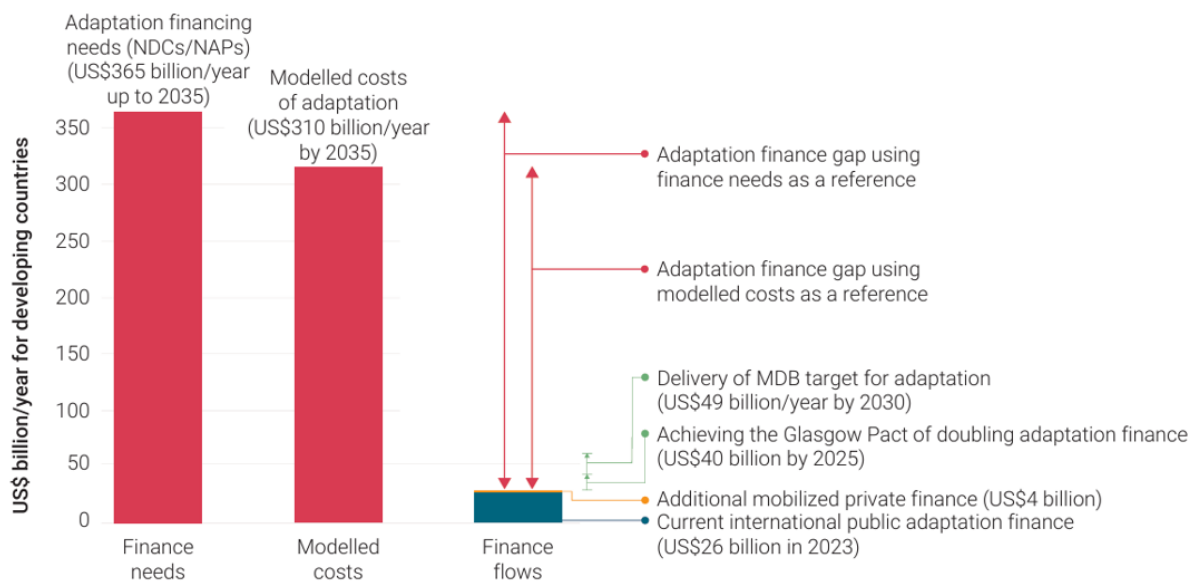


Source: NAP central – LDC Expert Group (LEG)

Again, it appears likely that the level of adaptation progressiveness going forward will boil down to the financing question. For example, African and Arab nations called for a two-year postponement of the GGAs on November 13 due to concerns that some of the indicators in their view shifts the financial responsibility of climate adaptation onto the developing countries.

Accordingly, following on from COP26 in Glasgow in 2021 when countries agreed that climate adaptation financing was to reach about USD40bn by 2025 – the Least Developed Countries (LDC) grouping has proposed for this to be tripled to USD120bn by 2030. As of Friday morning, the draft COP30 deal called for such a tripling, but did not specify if the money should be provided directly by developed countries or include other sources such as development banks and the private sector. Notably, UNEP estimates that international public adaptation finance flows totalled US\$28bn in 2023. UNEP further projects that the cost of adaptation finance in developing countries could be as high as USD365bn per year in 2035 (see graph below). This highlights the strong need for adaptation finance going forward.

Comparison of adaptation financing needs, modelled costs and international public adaptation finance flows in developing countries



In constant 2023 prices. Domestic and private finance flows are excluded. Source: UNEP.

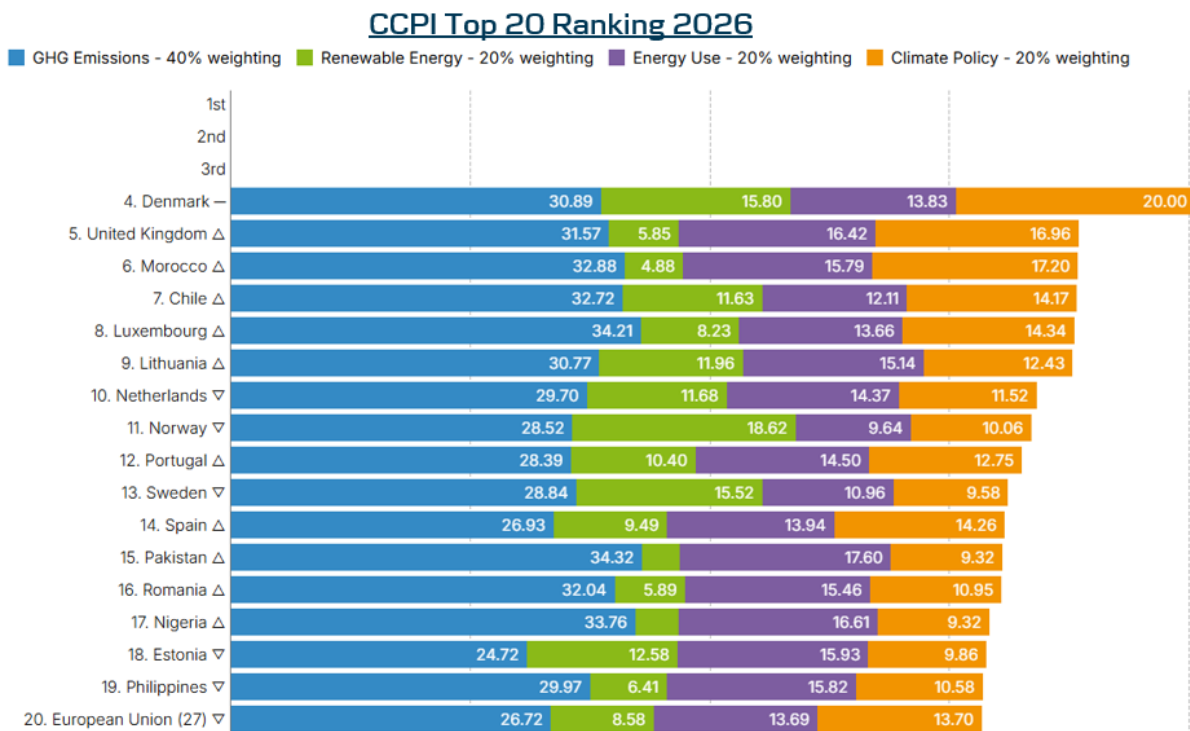
In brief:

- AXA IM secures USD560mn for natural capital strategy.** AXA IM has received over USD560 million in commitments for its Natural Capital and Impact investments strategy, following support from major development finance institutions such as the IFC, Proparco, and DEG. Launched in late 2022, the strategy focuses on protecting and restoring natural capital through nature-based projects and equity investments in companies advancing the sector.
- EIB launches global Green Checker tool to boost sustainable financing.** The European Investment Bank (EIB) has globally launched its Green Checker tool, enabling banks and businesses outside the EU to identify and access green financing opportunities. The tool assesses project eligibility and estimates climate impact, ensuring consistency with EU Taxonomy and EIB climate standards. Initially designed for financial intermediaries, however it is free and publicly accessible.
- The European Parliament backs new 2040 climate target.** The target, which gained Parliamentary approval on November 13, introduces a binding target of a 90% reduction in GHG emission by 2040, compared to 1990 levels. This followed the proposal having been endorsed by the European Council just ahead of COP30, meaning the EU delegation did not have to arrive empty handed at the conference. The amendment also introduces some scope for flexibility for the member states, such as the possibility to use

high-quality international carbon credits quantified as up to 5% of 1990 net emissions.

- Transition finance guidelines released by International Capital Markets Association.** The guidelines introduce a dedicated Climate Transition Bond (CTB) label designed to help finance critical projects for achieving the goals of the Paris Agreement, especially from those in high-emitting sectors and/or with high-emitting activities – aligning closely with the Loan Market Association’s guide to transition loans, released last month. The guidelines also include preliminary and non-exhaustive project categories including Carbon Capture Utilisation and Storage, early retirement and decommissioning of high-emission assets, and fossil fuel switch. The guidelines also make recommendations for high-emission issuers with regards to climate transition-themed Sustainability-Linked Bonds.
- Denmark scores highest in annual Climate Change Performance Index (CCPI) ranking for the fifth year in a row.** Published since 2005 by Germanwatch, the CCPI serves as an independent monitoring tool to evaluate the climate mitigation performance of 63 countries and the EU. Denmark maintained its 4th place, as no country performed strongly enough across all categories to earn an overall “very high” rating, leaving the top three spots vacant (see graph of the month below). Norway and Sweden both dropped two places, ranking 11th and 13th respectively, while Finland climbed eight places to reach 29th in the ranking.

Graph of the month:



Source: CCPI

Sustainable product deep-dive: SFDR 2.0 pivots from disclosure to product categorisation regime

Following leaks earlier this November, the European Commission announced its proposed set of amendments to the Sustainable Finance Disclosures Regulation (SFDR) yesterday. The proposed update to the regulation that entered into force in 2021, referred to as SFDR 2.0, follows years of heavy criticism against what has been by some considered a cumbersome disclosure regime marred by uncertainty over definitions.

SFDR 1.0 has been plagued by several challenges

In short, the original SFDR (1.0) requires financial market participants to disclose how sustainability is integrated into their investment processes. SFDR 1.0 has key concepts such as:

- **Fund categorisation:** Funds are classified as Article 6, 8, or 9 based on their sustainability focus. Article 6 funds have no sustainability integration, Article 8 funds promote environmental or social characteristics, and Article 9 funds focus solely on sustainable investments.
- **Principal Adverse Impact (PAI):** Funds must disclose whether they consider PAI indicators, which capture potential negative impacts on environmental, social, and governance (ESG) matters, including human rights, anticorruption, and antibribery issues.
- **'Sustainable investments':** Defined as investments contributing to environmental or social objectives, without significantly harming other objectives, while ensuring good governance practices. Article 9 funds can only make sustainable investments, and both Article 8 and 9 funds must disclose the proportion of investments classified as sustainable or aligned with the EU Taxonomy.

Reflecting market concerns, the European Commission identified several shortcomings in the 1.0 of the regulation that it now seeks to address. These include lack of clarity on what constitutes a 'sustainable investment' – which led to inconsistent application across the market and hindered the regulation's original goal of enhancing investor protection for sustainable products. Collecting PAI data has also proven burdensome and ineffective as a proxy for ensuring no harm.

SFDR 2.0 moves from disclosure to categorization focus

Originally designed to standardise sustainability disclosures, SFDR 1.0 was a broad framework that gave asset managers flexibility in defining funds' social and environmental ambitions. As IEEFA notes, this confused investors – particularly retail investors - with problems deepening when what effectively were self-determined article 8 and 9 designations became "shorthand for sustainability quality, effectively turning a disclosure regime into a de facto labelling system".

As such, SFDR 2.0 now takes a big step towards formalizing the regulation's role as a product categorization system, while stripping away the elements that increased confusion, uncertainty and added significantly to administrative burdens. Key changes include:

- **New fund categorization:** SFDR 2.0 introduces three product categories - a new Article 7 category for climate transition funds, alongside revised requirements for Article 8 and 9 funds. Article 7 (transition) pertains to products investing in companies that are not yet sustainable but with credible transition plans. Article 8 (ESG basics) will require an overall strategy for integrating ESG factors, while Article 9 (Sustainable) will now require an allocation of 70% of funds to assets that make a positive contribution to sustainability – down from the current 100% in SFDR 1.0. All categories now adopt the 70% allocation requirement related to the article objective. For Transition (article 7) and Sustainable (article 9) funds, the 70% threshold can be bypassed if EU taxonomy alignment of over 15% can be documented.
- **Dropping “sustainable investment” definition:** The inconsistency of application of SFDR 1.0 in this regard have been source of heavy criticism. For example EDHCEC Climate Institute (ECI) found in an analysis that out of 161 article 9 funds assessed, 50 contained stocks of companies involved in coal, oil, gas or aviation – which in turn on average made up 2.8% of the funds' invested capital. The argument now is that the labels themselves can provide the clarity needed, with the devil set to be in the details of upcoming delegated acts which would translate the labels to enforceable criteria.
- **Dropping PAIs:** The revised regulation eliminates the requirement for entity-level PAI disclosures, significantly reducing the administrative burden on asset managers. This change is expected to streamline compliance and enhance clarity regarding the sustainability objectives of funds. Instead, all funds must use credible sustainability-related indicators to assess compliance with category-specific criteria, which may align with those outlined in the revised CSRD.
- **Mandatory exclusions:** As PAIs have been deemed to not having led to a robust or comparable mechanism in ensuring no harm – SFDR 2.0 seeks to replace the existing approach with applying the exclusions of the most harmful sectors as outlined by the European Securities and Markets Authority (ESMA) fund-naming guidelines.

	Transition related products [Article 7]	Products integrating sustainability factors [Article 8]	Products with a sustainability related objective [Article 9]
Objective	"Aim to support the transition of companies, or assets towards more sustainable business practices"	"Integrate sustainability factors into their investment strategy, going beyond basic risk management"	" <u>have</u> a primary goal of achieving positive environmental or social outcomes (e.g., climate change mitigation, biodiversity protection)."
Requirements: At least 70% of investments must be...	...linked to a clear and measurable transition objective, using credible sustainability indicators	... integrate sustainability factors, measured by credible indicators (such as ESG ratings or performance on specific sustainability metrics).	... dedicated to achieving clear and measurable sustainability objectives, using credible indicators.
Exclusions (Replace DNSH)	Investments in companies or activities considered most harmful (as defined by EU regulations) are excluded.	Investments in companies or activities considered most harmful (as defined by EU regulations) are excluded.	Stricter exclusions apply, including companies involved in fossil fuel expansion and other activities contrary to sustainability goals.
Examples	Products tracking EU Climate Transition Benchmarks or investing in companies with credible transition plans. +15% EU-Tax shortcut.	Funds that systematically favour companies with strong ESG performance or apply robust ESG screening.	Funds aligned with the EU Taxonomy for sustainable activities, Paris-aligned benchmarks, or those investing in green bonds and similar instruments. +15% EU-Tax shortcut.

Source: Danske Bank

As such, after several years of uncertainty, SFDR 2.0 provides increased clarity on the direction of travel for asset managers by introducing a more streamlined and prescriptive regulatory framework for sustainable finance in Europe. The revised regulation clarifies fund categorisation, reduces administrative burdens, and places greater emphasis on labelled bonds - particularly for public sector issuers. The result appears to be a genuine simplification outcome – against the backdrop of concerns that the EU Omnibus for sustainability reporting is at risk of moving towards de-regulation. The SFDR 2.0 will go now into trilogue, it remains to be seen what positions the European Parliament and Council will now adopt.

Labelled bonds set to benefit from SFDR 2.0

While the new SFDR 2.0 requirements offer increased flexibility for portfolio construction, they also introduce more demanding eligibility criteria. These changes are expected to drive broader adoption of labelled bonds and facilitate investor participation in sustainable finance markets. Some key takeaways include:

- **Enhanced regulatory recognition of European Green Bonds:** Notably, the EU Green Bond Standard (EU GBS) is positioned as a key instrument, as EU Green Bonds will automatically qualify for all fund categories and play a pivotal role in meeting eligibility thresholds. This automatic eligibility is expected to materially simplify investment decision-making and facilitate

increased investor demand for European Green Bonds. In addition, European Green Bonds contribute directly to a fund's EU Taxonomy alignment. This is of relevance, considering that funds achieving at least 15% Taxonomy alignment are exempt from the otherwise stringent 70% eligible investment threshold – further cementing the relevance of taxonomy alignment.

- **Public Sector restrictions to benefit use-of-proceeds bonds:** For public sector issuers, only use-of-proceeds bonds that comply with Paris-Aligned Benchmark (PAB) exclusions or are issued under the European Green Bond Standard will be recognized towards the 70% threshold. The fact that only use-of-proceeds bonds are recognized under SFDR 2.0 is expected to significantly increase the importance of labelled bonds for public sector entities. Labelled bonds are likely to become crucial instruments for these issuers, as they facilitate investor diversification and enable broader investor participation.
- **Improved regulatory fit for Green Bonds:** Conventional Green Bonds are also expected to benefit from the revised regulation. These instruments typically satisfy the mandatory exclusions and exemplify the integration of sustainability factors beyond traditional risk management. The revised framework's emphasis on sustainability integration and issuer-level disclosures further enhances the suitability of conventional Green Bonds for inclusion in Article 8 and Article 9 funds.
- **Sustainability-linked bonds – evolving relevance:** The regulatory treatment of SLBs under SFDR 2.0 remains somewhat nuanced. SLBs featuring credible transition plans and science-based targets are likely to align well with Article 7 funds and may also qualify under Article 8. The practical implementation by investors will be critical in determining the extent to which SLBs are incorporated under the new regime

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