EFAMA RESPONSE TO THE CALL FOR FEEDBACK ON TEG REPORT ON EU TAXONOMY

16 SEPTEMBER 2019

SUMMARY

We support the aim of the EU taxonomy which is to promote investment in sustainable projects and help investors and companies make informed investment decisions by helping to define environmentally sustainable economic activities. We also welcome the improvements to the TEG’s proposals, e.g. regarding inclusion of enabling and transition activities.

However, we have concerns over:

- availability and quality of ESG data on investee companies;
- feasibility of its application especially at the portfolio level;
- its relevance for different asset classes;
- alignment with other sustainable finance rules;
- potential to mislead end-investors in case appropriate investment education is not provided;
- lack of appropriate transition & timeline.

Given the challenges, it is imperative that the EU Taxonomy remains voluntary. Making it mandatory without corresponding ESG data on investee companies would result in high liability risks for product providers and could impair further development of the market for sustainable investments. Furthermore, a proper transition phase, during which a simplified approach could be envisaged, is key.

Moreover, without appropriate consumer education, we fear that the introduction of the EU taxonomy could lead to unintended consequences of misleading end users. We urge that the promotion of the taxonomy be supplemented by relevant consumer education to ensure that we avoid the repeat of PRIIPs.

In terms of more detailed comments, while we understand why expenditures contributing to one or more environmental objectives, are to be considered within the EU Taxonomy. However, this increases the complexity of the taxonomy and its application. It may be extremely difficult or even impossible to combine the information, especially for investments in large companies, when certain economic activities are considered eligible on the basis of revenues (thus equivalent to turnover), while others are considered on the basis of the related capital expenditures. This is particular problematic in relation to public equity. We encourage the TEG to work on a simpler and practical solution.

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RESPONSES TO SPECIFIC QUESTIONS

3. Usability of the taxonomy

1. Do you expect to use the Taxonomy in your business activities in the short term (1-3 years) or long term (4 years or more)?

☐ Yes
☐ No
☐ Don’t know / no opinion / not relevant

If yes, please indicate when (short term or long term) and specify the activities for which you will use the Taxonomy.

We support the aim of the EU taxonomy which is to promote investment in sustainable projects and help investors and companies make informed investment decisions by creating a “dictionary” for classifying environmentally sustainable economic activities. We also welcome the improvements to the TEG’s proposals, e.g. regarding inclusion of enabling and transition activities. However, we have concerns over 1) availability and quality of data on investee companies; 2) feasibility of its application especially at the portfolio level; 3) its relevance for different asset classes; 4) alignment with other sustainable finance rules; 5) potential to mislead end-investors in case appropriate investment education is not provided; 6) lack of appropriate transition & timeline. Given the challenges, we question whether it will be possible to apply the EU Taxonomy in the short-term.

Consistent, comparable, quantitative and publicly available ESG disclosures are essential for asset managers to be able to apply EU taxonomy and comply with sustainable finance requirements. The technical criteria are based on specific quantitative threshold, for instance in terms of GHG emissions, hence compliance with these criteria can only be assessed by the individual companies. Without specific, quantitative and reliable reporting by companies, it will not be possible for asset managers or sustainable rating agencies to consider the alignment of an investment with the EU Taxonomy. Meanwhile, company disclosure would require significant reform to meet the requirements of the Taxonomy and, at minimum, this would take time. Global cooperation regarding ESG data disclosure would be helpful to ensure a level playing field, comparability for investors and to avoid market fragmentation.

The timeframe of this consultation (open mostly over the summer) made it difficult to have a proper discussion with our members. Moreover, the format with very stringent character limits, constrained the expression of views.

2. Can the Taxonomy be made more useful for disclosures related to your specific financial product? This question covers only financial products where disclosure obligations are foreseen by the Taxonomy proposal.

☐ Yes
☐ No
☐ Don’t know / no opinion / not relevant

Which specific financial product(s) did you have in mind?

☐ Portfolio management
☐ UCITS funds
☐ Alternative investment funds
☐ Insurance-based Investment Products
☐ Pension products and pension schemes
How could the Taxonomy be made more useful for Portfolio management?

- The taxonomy focuses on the economic activity level. It is not easy to aggregate that up at company level and even more difficult at portfolio level. It would be more appropriate to evaluate company’s sustainability based on its forward looking strategy and targets instead of a proportion of economic activities.

- It would be useful that the EU taxonomy explains how it can be applied to different asset classes. The taxonomy will be easier to apply for direct investments in projects or assets overall qualifying as environmentally sustainable. Direct investments in sustainable bonds like green or social bonds, real estate or direct project financing is much easier to quantify. However, such investments are not considered as core elements of a diversified portfolio either for retail or institutional investors. Application of taxonomy to securities on the secondary market, and equity in particular, makes it very challenging.

- Asset managers need consistent, comparable, quantitative ESG disclosures by investee companies. Alignment of public equity with EU taxonomy cannot be assessed without dedicated reporting by issuers. Large companies have multiple business lines and thus screening with the technical criteria at the activity level can be conducted by the issuer only. It is similar with investment into sovereign bonds which without further disclosures will mostly not qualify as environmentally sustainable.

- The requirement for product manufacturer to engage in “preventing or mitigating adverse impacts” as part of due diligence on the DNSH criteria is not compatible with the general approach of the taxonomy aiming at identifying environmentally sustainable activities.

Given all the challenges, EU Taxonomy should remain voluntary. Making it mandatory without corresponding ESG data on investee companies would result in high liability risks for product providers and could impair further development of the market for sustainable investments.

How could the Taxonomy be made more useful for UCITS funds?

See our comments on how to make taxonomy more useful for portfolio management. Moreover, please note that:

- In general, UCITS are set up as investment vehicles dedicated to the mass retail market, i.e. offering broad diversification of risk and daily liquidity. UCITS funds can invest in public equity, sovereign and corporate bonds, while application of taxonomy to public equity and sovereign bonds is challenging.

- Lack of appropriate ESG data on investee companies would effectively exclude practical application of the taxonomy for environmentally sustainable strategies offered in a UCITS wrapper.

- It is imperative that there is a general understanding across consumers on what the disclosure against the taxonomy actually means. It will be of great concern if consumers start to use revenue percentages to compare across products and conclude that a higher percentage disclosure against the Taxonomy means a more sustainable product. Without appropriate consumer education, we fear that the introduction of the Taxonomy could lead to unintended consequences of misleading end users. We urge that the promotion of Taxonomy be supplemented by relevant consumer education to ensure that we avoid the repeat of PRIIPs.

How could the Taxonomy be made more useful for Alternative investment funds?

See our comments on how to make taxonomy more useful for portfolio management and for UCITS funds. Moreover, please note that:

- AIFs may invest in green bonds, project financing and real estate. But they are mostly used as additions to risk-diversified AIF solutions, e.g. in multi-asset funds (except for real estate). And in any case, similarly to UCITS, AIF investments are mostly in public equity, sovereign and corporate bonds.

3. Can the Taxonomy be made more useful for your investment decisions in different asset classes?

- [ ] Yes
- [ ] No
- [ ] Don't know/no opinion/not relevant

Which asset class(es) did you have in mind?

- [ ] Public equity
How could the Taxonomy be made more useful for public equity?

2000 character(s) maximum

As mentioned in response to previous questions, applying the EU taxonomy to public equity is very challenging. Meanwhile, public equity is the core asset class for both retail and institutional funds.

- There is the need for consistent, comparable, quantitative ESG disclosures by investee companies. Otherwise, neither fund managers nor ESG rating agencies will be able to verify whether the relevant technical thresholds for the economic activities have been met.
- The technical screening criteria are for some activities relevant in terms of revenues, for other in terms of investments enabling certain measures. Thus, it will be a major challenge to establish a percentage of Taxonomy-aligned activities for a large company. Therefore, the industry needs a clear guidance on how to determine alignment with the taxonomy for equity investments.
- Given all the challenges, a proper transition phase is key. We would suggest to consider a simplified approach during a transition phase. E.g. product manufacturers could be allowed to consider the entire equity investment as environmentally sustainable in case a significant part of revenues by a company results from taxonomy-compliant activities.

How could the Taxonomy be made more useful for corporate bonds?

2000 character(s) maximum

To ensure sufficient uptake and success of the EU Taxonomy, it should be workable for all asset classes. E.g. it should be applicable not only to bonds that were issued as green or dedicated to financing of green projects only, but also to traditional corporate bonds. In case of corporate bonds, the degree of alignment with the taxonomy could refer to the issuer and be assessed based on the extent of its environmentally sustainable activities. Please see our comments above which apply also in this case.

How could the Taxonomy be made more useful for other assets?

2000 character(s) maximum

To ensure sufficient uptake and success of the EU Taxonomy, it should be workable for all asset classes. We would suggest that it should, amongst others, accommodate for sovereign bonds, beyond those issued specifically as green bonds or dedicated to the financing of green projects. We would thus encourage the TEG to work on possible approaches to assessing alignment of sovereign issuers with the Taxonomy.

4. Is it sufficiently clear when the entire activities of a company or other entity should be considered as Taxonomy eligible (revenues or turnover) and when only expenditures by companies or other entities should be considered Taxonomy eligible?

☐ Yes
☒ No
☐ Don't know / no opinion / not relevant

If no, it is not sufficiently clear, please specify how this could be made clearer.
Whenever expenditures contribute to one or more environmental objectives, we understand why they are to be considered within the EU Taxonomy. However, this increases the complexity of the taxonomy and its application.

It may be extremely difficult or even impossible to combine the information, especially for investments in large companies, when certain economic activities are considered eligible on the basis of revenues (thus equivalent to turnover), while others are considered on the basis of the related capital expenditures. This is particular problematic in relation to public equity. We encourage the TEG to work on a simpler and practical solution.

Moreover, the tables proposed in the TEG report are not clear on whether certain activities shall be assessed based on revenues or capex. We suggest introducing a dedicated line specifying the relevant base for reference in each table.

5. What practical tools or measures could be developed to facilitate the implementation of the taxonomy by financial actors?

Please specify what these tools would be used for and provide sufficient explanation on how they can help to implement the taxonomy:

An online user guide seems like a good idea. Also, see our responses to other questions.