

EFAMA'S FEEDBACK ON THE DRAFT DELEGATED ACT OF THE TAXONOMY REGULATION FOR CLIMATE CHANGE MITIGATION AND ADAPTATION

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INTRODUCTION

As the voice of European asset management industry, EFAMA strongly welcomes the development of the EU Taxonomy and its technical screening criteria. We see the Taxonomy as a critical tool to unleashing the potential of sustainable finance in Europe by assisting issuers, project promoters, companies, investors, and other financial market participants in identifying truly sustainable economic activities. We wish to put forward recommendations that aim to improve the usability and integrity of this framework.

The Delegated Act (DA) will make the EU Taxonomy operational by determining which investments make substantial contribution to climate change mitigation and adaptation, whilst avoiding harm to other environmental or social objectives. Its proposed technical screening criteria (TSC) will be fundamental in guiding investment decisions of financial market participants and, increasingly so, public authorities. Moreover, given the scale of the EU internal market, the Taxonomy is likely to have a reach also in non-EU jurisdictions.

We would like to share asset managers' feedback on the challenges in making the Taxonomy work in practice. This position paper offers 26 policy recommendations towards the technical screening and "do no significant harm" (DNSH) criteria; implementation difficulties related to timeframes, investment plans and financial products, as well as challenges related to the availability of ESG data.

KEY HIGHLIGHTS

1. We are concerned that the proposed criteria for construction, renovation and ownership of buildings would be detrimental to the decarbonization of EU's building stock by restricting the issuance of Taxonomy aligned green bond volumes. The stringency and reduced economic viability of the criteria would be particularly counterproductive for the covered bond and green mortgage bond markets. As a result, the potential of the Taxonomy to lower the costs of sustainable housing and real estate development would be significantly reduced. Furthermore, the linkage of TSC for "building acquisition and ownership" to Energy Performance Certificates could, due to their different absolute energy thresholds in Member States, create an unlevel playing field in the EU internal market for green bond issuance.
2. The science-based review of the TSC every three years could lead to concerns over the future Taxonomy alignment of financial products where underlying investment projects have longer timeframes. Therefore, Taxonomy alignment at the time of issuance of the financial product or instrument should apply for the products' entire duration, or for a sufficient period of time to mitigate concerns over future TSC non-alignment.
3. Given the ESG data challenge, the current timeline for application of Taxonomy disclosures continues to pose a serious challenge. We recommend readjusting the disclosure timelines to ensure a more practical and seamless sequencing between the reporting done by companies and asset managers. As users of these information, asset managers must be able to rely on reliable and comparable company disclosures. We are concerned that most companies will not be ready to implement the new disclosure requirements by January 1st 2022, leaving financial market participants with no option but to rely on estimates and third party screenings. In this context, we also call on the

European Commission to clarify the conditions under which market participants can rely on due diligence screening produced in-house or acquired from external data providers.

4. Prioritising the revision of NFRD to extend its scope, the development of EU reporting standards, greater reliance on third party verification and the establishment of the European Single Access Point could address the problems related to the insufficient availability of meaningful, reliable, comparable, and public ESG data.
5. Given the globalized character of financial markets, we suggest increasing the international relevance of the EU Taxonomy to the extent possible and leading a conducive dialogue with jurisdictions showing interest in sustainable finance policies. The role of the International Platform on Sustainable Finance is key in this respect.

A. Technical screening criteria

Construction of new buildings (7.1): The requirement to undercut the national Net-Zero Energy Buildings (NZEB) threshold by 20% is in the view of our members too ambitious, given that the development of such buildings would become economically unviable. The 20% Primary Energy Demand (PED) reduction could be particularly detrimental to the covered bond and green mortgage bond markets in countries with stricter levels of Energy Performance of Buildings Directive (EPBD).

1. We recommend making use of existing standards instead of adopting new ones. Therefore, we suggest linking the sustainability criteria for newly constructed buildings to the national NZEB threshold, instead of undercutting it by further 20% in PED. It is also important that an operational measure, such as Energy Performance Certificate (EPC) ratings, should provide documentation that a building meets the required criteria. This would improve the usability of the Taxonomy for owners of buildings and other stakeholders.

DNSH criteria for construction of new buildings (7.1): According to the proposed DNSH for buildings, a building should not be built on arable, crop or forest land. This kind of vague description could mean that there is no land in certain Member States eligible as building site.

2. It needs to be specified what constitutes crop land and what is forest land, as the understanding of these concepts can be different between Member States.

Renovation of existing buildings (7.2): Eligible renovations will either be compliant with the applicable requirements for major renovations or lead to a reduction of PED by at least 30%. We are concerned that in many instances, renovation of existing buildings which would lead to a reduction of PED by at least 30% may not be technically feasible, nor economically viable.

3. When a renovation is compliant with requirements for major renovations, then not only the CapEx for the renovation should be Taxonomy eligible, but also the entire value of the building. In our view, this clarification would strongly incentivize the renovation of older buildings. Moreover, buildings and renovations are often financed with a mortgage loan, which is typically provided as a full loan based on the value of the entire property. From both the perspective of the borrower and the bank, a separation of green and “traditional” financing relating to the same property would not be feasible.
4. Buildings renovated in line with the Taxonomy criteria under 7.2 should qualify as Taxonomy-compliant during the entire period of an investment. At least, the qualification as Taxonomy-compliant should apply temporarily, e.g. for a period of 3 years. This would significantly expand the relevance of the Taxonomy and encourage the real estate sector to invest in projects and measures reducing the GHG emissions.

5. A stronger focus should be put on cost-effective partial renovations and other small-scale measures. Although these measures result in lower energy savings compared to full renovations, they can make a considerable contribution to climate protection in the short and long term due to the high absolute savings.

Ownership and acquisition of buildings (7.6): We maintain that the proposed threshold would be counterproductive to the renewal of EU's building stock by limiting the issuance of Taxonomy aligned green bond volumes by banks and the real estate sector.

We see it as problematic that the European Commission has changed the TEG's criterion recommendation for a 15% threshold of the building stock in terms of energy performance. Instead of providing further specification on this requirement in terms of reference areas and peer comparisons, the DA proposes a Class A EPC for all buildings built before 31 December 2020. However, the EPBD only sets general requirements for EPC, giving Member States flexibility to adjust the requirements for their national context. This leads to a fragmented EPC system with implementation differences in calculation methods, EPC thresholds, quality control, enforcement, and policy goals.

We therefore see the EPC Class A certification, at its current state of national implementation, as an inappropriate proxy for identifying the substantial contribution of a building to climate change mitigation. For example, in the Nordics, only very few buildings have a certificate class A or higher (in Finland only 1% of buildings have energy class A and in Denmark, this criterion would reduce the number of eligible buildings by 40%), whereas in other countries the proportion of eligible building stock can be tenfold.

Furthermore, in Germany there is a distinction between consumption- and the demand-related EPC. This distinction makes it more difficult to understand the energy certificates in the market. There are also significant differences in the price for issuing EPC. The price is in most Member States given by the market, whereas in others it is regulated by law or parts thereof, such as registration costs.

6. We propose returning to the TEG proposal for establishing a 15% threshold of the best energy performing buildings in the reference pool of buildings in a Member State. To operationalize this threshold, the European Commission should determine the reference building stocks and foster the development of national publicly accessible registers to collect the relevant data. It is also important the EPC certificates operationalize the threshold by providing documentation as to whether a building is eligible by belonging to the top-15%.
7. Should EPC Class A requirement be retained, the European Commission must address the problems of divergence in terms of quality, credibility, and usefulness of EPCs across Member States. We see a need for more legislation and guidelines for the implementation of EPCs at national level, aiding the standardization of national EPC systems. It would be also desirable to have a uniform basis and guidelines for issuing the EPCs, which should be publicly available in functional ECP databases in all Member States. Alternatively, to ensure that the criterion can be easily and directly applied, buildings with at least EPC Class B should be considered eligible.

Additionality in forestry-related activities (1): The Commission's request for "additionality" in forest management means that only measures above or beyond "ordinary" forest management can be classified as sustainable. This requirement would mean that all ordinary sustainable forest management would be excluded by the TSC, contrary to the TEG's advice. As these measures are only marginal in comparison to the ordinary sustainable forest management, the climate benefit would be also marginal. For example, 90 % of forests used for commercial purposes in Finland are certified by the Program for the Endorsement of Forest Certification, implying that sustainable forest management is already an established standard.

8. We recommend removing or adjusting the additionality criteria for forestry management, in order to make eligible also existing forestry activities that are conducted in accordance with highest existing sustainability standards.

Science-based approach to production of energy from the nuclear fuel cycle (4): Nuclear energy is not listed amongst Taxonomy-eligible activities despite its important contribution to decarbonization of the energy mix in certain EU Member States and, increasingly so, in industrializing G20 countries.

9. Possible inclusion of nuclear energy as a taxonomy-compliant transitioning activity should evolve from a science-based approach, devoid of partisan or ideological considerations. We believe it should be based on conclusions of the ongoing study of the Joint Research Centre on the status and long-term management and disposal of nuclear waste (as per DNSH criteria and Taxonomy Regulation Article 13 on Circular Economy). We also stress that such projects must significantly contribute to the decarbonization of the energy mix and be supported by the relevant authorities.

Financial and insurance activities for climate change adaptation (1c): The point 1c specifies that insurance activities should provide incentives for risk reduction by acting as a price signal of risk, including reduced premiums or deductibles to policyholders. However, we note that the premium's calculation is already based on the risk level as required by the principles of the Solvency 2 Directive. Pricing is based on actual risks and therefore it already considers existing prevention and/or protection measures, including against climate risks. Therefore, the current wording of this criterion goes against the principle of actuarial pricing: it assumes that the price is set first and that a discount linked to preventive actions can be deduced afterwards. A "price signal" is incompatible with the general principle of risk pooling.

10. We recommend that the Delegated Act removes point c under criterion 1 for substantial contribution to climate change adaptation by financial and insurance activities.

Climate change adaptation DNSH requirement for mitigation activities in Annex I: The Commission has made the DNSH criteria for mitigation activities less strict by removing the obligation to reduce 'all' risks and requiring new activities to have a plan to implement the adaptation solutions only within the next 5 years (rather than having them implemented from the start). We welcome the amendment as it reflects better the current market conditions.

11. We believe this criterion should apply only for new investments and financing projects. This would also be in line with the proposed focus on CapEx for adaptation activities. It should also take into account the specific context in which it is applied by including the principles of proportionality, principal-agent and a risk-based approach. For example, in case of green mortgages, it makes little sense for a household to conduct the evaluation - this should fall under the responsibility of the municipality.

B. Implementation challenges related to timeframes, investment plans and financial products

Addressing cliff-edge effects: The tightening of the TSC must also address the implications for companies and financial products. The EU Taxonomy is designed as a dynamic framework, particularly in relation to the transition activities where the criteria are set to be reviewed every 3 years. This improved predictability of criteria reviews is welcome. However, many investments in environmentally sustainable activities will be long-term in nature, potentially beyond the 3-year review clause, creating uncertainty for investors and a potential barrier to such long-term investments.

This problem will also arise for financial instruments and products with different investment timeframes compared to the revision timeframes of the TSC. Investors may be hesitant to invest in an activity that is currently Taxonomy-aligned, but whose alignment may be removed during the lifetime of the investment. Green bonds, loans, mortgages and use green use of proceeds debt products will be particularly affected by this problem.

12. We encourage the European Commission to establish appropriate practices in accounting for Taxonomy-alignment of different financial instruments, where the timeframe of the underlying investment or project is considerably longer than the timeframe for revision of the TSC. Such practice could consist of Taxonomy “grandfathering” whereby the Taxonomy alignment at the time of issuance of the financial product or instrument would apply either for the entire duration of the financial instrument, or for a sufficient period to mitigate concerns of future divergence.
13. To provide investor certainty and predictability, assets, such as green buildings, should keep the status as Taxonomy aligned throughout the lifetime of the loan financing the asset. Issuers of covered bonds should be allowed to base their periodic reporting on the greenness of the collateral in the cover pool using the version of the Taxonomy in place at the time of granting the loans backing the bond.

TSC review consistency with the EU ETS benchmarks: The value of the EU Taxonomy stems from its consistency and alignment with EU policies and goals. Recital 40 states that in order to ensure that the application of Regulation (EU) 2020/852 evolves with technological, market and policy developments, the Regulation should be regularly reviewed and, where appropriate, amended with regards to the climate change mitigation and adaptation TSC.

14. The review of EU Emission Trading System (EU ETS) benchmarks referenced in a number TSC for “economic activities in transition” should be coordinated with the TSC reviews. The two reviews should be conducted at the same time to maximize the effectiveness of the TSC’s linkage to EU ETS benchmarks and close potential loopholes.

Timeframes of CapEx and investment plans: We welcome the TEG suggestion that for both environmental objectives, a non-financial undertaking should be able to include CapEx when it is part of a plan to meet the TSC for a substantial contribution to climate change mitigation / adaptation and relevant DNSH criteria. This means CapEx can be counted only if the plan towards which it delivers makes the economic activity in question Taxonomy-aligned within a maximum period of five years.

15. While we agree with the 5-year timespan as a general rule, we recommend introducing an exception for large infrastructure projects whose proven financing and/or construction timespan largely exceeds the timeframe. EFAMA has tabled this exception to projected CapEx eligibility also in its consultation response to the draft advice of ESMA on KPI reporting under Article 8 of the Taxonomy¹.

¹ https://www.efama.org/Publications/Public/Responsible_Investment/20-4069.pdf

We note that the eligibility of CapEx is dependent on the consistent and transparent disclosure of data, as well as on the ability of vendors providing ratings to standardize the outputs.

Disclosure timeline challenge: Disclosure obligations under Articles 5 and 6 will apply from 1st January 2022, but companies reporting on their Taxonomy-compliant activities will be reporting only during 2022 for the business year of 2021. This will lead to a several months long data gap for financial product disclosure on the Taxonomy. Furthermore, any changes to disclosures resulting from the upcoming NFRD review are likely to become applicable much later.

16. Taxonomy disclosure timeframes for asset managers reporting under NFRD should be aligned with deadlines for disclosures by non-financial undertakings. Timelines should be readjusted to ensure a more practical and seamless implementation sequencing between the Taxonomy, NFRD, EU GBS and EU Ecolabel. We recommend two possible solutions to address this problem:
 - o Level 2 measures could ensure legal certainty for market participants by clarifying that reasonable estimations of the EU taxonomy compliance are accepted as a transitional solution while promoting swifter implementation by companies.
 - o Alternatively, to provide companies with sufficient time to implement the new disclosure requirements and avoid reliance of asset managers on estimations, 2022 should be taken as a reference year for company and asset manager reporting on the first two environmental objectives and 2023 for the remaining three environmental objectives.
 - o At the same time, revision of the NFRD and the introduction of a European Single Access Point should be prioritized.
17. The principle of proportionality should be clearly enshrined in the Taxonomy Regulation – especially when applied to SMEs and to the different financial products.

C. ESG data and usability related challenges

DNSH and minimum safeguards due diligence: As acknowledged by the JRC, the screening against DNSH and the minimum safeguards will be met with great difficulties. Most companies do not disclose such information and it is also unclear how will market participants be able to verify the disclosed information.

Given that fund managers, especially in the initial years, may not be able to fully rely on corporate disclosures to evaluate alignment of their portfolios with the EU Taxonomy, the use of ESG controversy screens produced by way of due diligence in-house or performed by ESG data and rating providers will be key. This solution was also proposed by the TEG. Furthermore, a proportionate approach should be envisaged for investments in companies that fall outside the scope of the NFRD and EU Taxonomy reporting obligations, since access to the necessary due diligence information will be lacking.

However, it remains unclear whether due diligence will be accepted by regulators to assess compliance when referring to qualitative criteria for substantial contribution, minimum safeguards and for DNSH. Therefore, we recommend to:

18. Clarify to what extent and under what conditions can market participants rely on (DNSH) due diligence screening produced in-house and acquired from external data providers. This would provide more clarity and legal certainty to market participants.
19. Provide clarity on how to conduct such due diligence and on regulators' expectations on financial actors and intermediaries – especially verifiers – when assessing compliance by companies or other economic actors.
20. The principle of proportionality should prevail when conducting due diligence.

Availability and reliability of ESG data: The insufficient availability of meaningful, reliable, comparable and public ESG data on investee companies remains a key challenge for the screening against the EU Taxonomy TSC, making it difficult to check which companies and what percentage of their activities are aligned.

21. Greater reliance on third party verification to ensure the reliability of the information, as has also been suggested by the TEG in relation to the EU GBS, would help reassure investors that the information provided is reliable.
22. A central ESG database or a European Single Access Point would help investors understand and use Taxonomy disclosures. Besides information reported in line with the regulatory requirements, the database should include ESG information filed by companies from outside the scope of the legal requirements on a voluntary basis. The database would facilitate ESG data access to all market participants, as well as civil society and academics.
23. The scope of reporting obligations in line with the Taxonomy should be extended to cover at least (1) large non-listed undertakings that seek to raise capital on capital markets (e.g. by issuance of corporate bonds) and (2) non-EU undertakings that are also listed on a regulated market in the EU. In addition, individual reporting per company in a company group should be encouraged to provide investors with accurate data at the company level.
24. Develop a standardized official methodology, alongside specific guidelines to be used for those companies for which data is not available or only partially available. The Platform on Sustainable Finance should provide advice to the EC on the methodologies and guidelines. Financial actors should then disclose which percentage is estimated following the official methodology and which

percentage is not. This breakdown would provide the reader with the necessary information to assess and interpret the resulting figures.

Revenues and CapEx as the basis for reference: The TSC need to specify whether an activity can be accounted as aligned in terms of the respected revenues or only the associated investments and expenses.

25. Specify for each economic activity whether it can be counted as environmentally sustainable in terms of its revenues and CapEx, and if relevant, OpEx. In the case of renovation of buildings, we see great practical value in acknowledging the entire value of the renovated property instead of the mere expenses. In our view, this clarification would strongly incentivize the renovation of older buildings.

Guidance and support needed: Application of the Taxonomy will be very challenging at the beginning and therefore, support should be provided to the industry.

26. We suggest providing additional guidance on how to practically apply the EU Taxonomy and clarifying expectations in terms of accuracy of the disclosures – especially in the short- and mid-term, given the insufficient availability of ESG data. We also suggest organizing webinars on this topic. An on-line tool and a support line which market participants could call to get support and clarity if needed would be also very helpful.



About EFAMA

EFAMA, the voice of the European investment management industry, represents 28 Member Associations, 60 Corporate Members and 24 Associate Members. At end Q3 2020, total net assets of European investment funds reached EUR 17.6 trillion. These assets were managed by more than 34,200 UCITS (Undertakings for Collective Investments in Transferable Securities) and almost 29,400 AIFs (Alternative Investment Funds). At the end of Q2 2020, assets managed by European asset managers as investment funds and discretionary mandates amounted to an estimated EUR 24.9 trillion.

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