

BVI's suggestions for the Commission Delegated Regulation on a climate change mitigation and adaptation taxonomy

Response to the EU consultation on the inception impact assessment

BVI¹ welcomes the endeavours to create an EU-wide harmonised Taxonomy for sustainable investments. The Taxonomy is a very important and powerful tool for facilitating investments in sustainable economic activities. However, to reach this purpose and to come close to “shifting the trillions” needed for achieving the environmental goals of the EU, the level of ambition of the Taxonomy must be carefully balanced against practicability and viability for market participants. In this regard, we see the need for the following adjustments and clarifications at Level 2:

- 1. Proper rules for the phasing-in period:** The disclosure obligations for financial products marketed as sustainable under Articles 5 and 6 of Level 1-Regulation shall apply from 1 January 2022. However, the obligation for large undertakings to report the proportion of their Taxonomy-compliant economic activities as part of the non-financial statement will also take effect from this date. In our understanding, this means that companies will be required to provide this information for the first business year commencing after 1 January 2022. Assuming our interpretation is correct, first reports by companies will be available in the course of 2023. This means a gap of more than one year between the application of disclosure obligations for financial products and the availability of relevant data from companies.

This situation is very unsatisfactory. **Appropriate solutions must be found in order to facilitate the phasing-in period of the Taxonomy and to align as closely as possible the disclosure timelines for companies and investors.** In particular, it must be prevented that most financial products report zero percent compliance with the Taxonomy criteria in the first year(s) just due to the lack of relevant information. The Level 2 measures should provide clarity about legitimate approaches to tackle this problem.

- 2. Availability of data and central repositories:** Even after becoming operational, reporting by large undertakings under Article 8 of the Taxonomy-Regulation will only partially resolve the problems with the unavailability of relevant data. Since the reporting obligation is linked to the scope of application of NFRD, it will so far not pertain to (1) undertakings listed on a regulated market with less than 500 employees, (2) non-listed undertakings in general and, most importantly (3) to any undertaking or group of undertakings located outside the EU. For fund managers investing globally on behalf of European investors, the persisting lack of information about Taxonomy compliance of non-EU issuers will create huge problems. Around 43% of the equity assets held by German retail funds are invested outside the EU; for institutional funds the share of non-EU investments is even higher with 53%². According to the research by Morgan Stanley, approximately 30% of European

¹ BVI represents the interests of the German fund industry at national and international level. The association promotes sensible regulation of the fund business as well as fair competition vis-à-vis policy makers and regulators. Asset Managers act as trustees in the sole interest of the investor and are subject to strict regulation. Funds match funding investors and the capital demands of companies and governments, thus fulfilling an important macro-economic function. BVI's 114 members manage assets more than 3 trillion euros for retail investors, insurance companies, pension and retirement schemes, banks, churches and foundations. With a share of 22%, Germany represents the largest fund market in the EU. BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.

² As of January 2020; source: German Bundesbank statistics.



ESG funds accounting for approximately 40% of AuM are global³. Non-European countries, such as the United States, Japan and Canada, represent more than 70% weight of the MSCI World Index.

In order to tackle this problem at least in the long run, we deem the following measures necessary:

- 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 (i.e. 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 envisaged in order to provide investors with accurate data at the company level.
- The **revision of NFRD should be pushed forward** as one of the priority files in relation to sustainable finance. Even in view of the difficult situation regarding the current COVID 19 crisis, a delay of the process should be avoided in any event.
- The EU should create a **central database for filing of company reports** in relation to the Taxonomy. Such EU database could be very helpful for accessing data reported by companies especially on voluntary basis, either before entry into force of the legal obligations or generally by issuers not covered by the scope of NFRD. Investors would be able to direct to one single access point in order to determine which companies have provided disclosures facilitating their assessment against the Taxonomy criteria. This would be a significant progress in terms of practical implementation and should especially help smaller asset managers who may not be able to afford subscriptions of comprehensive ESG data from commercial vendors.
- A **central repository is also badly needed for data relating to energy and carbon emissions of properties**. For assessing substantial contribution to the climate change mitigation in the context of activity 8.4 (acquisition and ownership), the TEG recommends that buildings built before end 2020 must belong to the top 15% of the local existing stock in terms of operational Primary Energy Demand (PED). Reference data for assessing the energy performance of local properties is currently not available in many markets. An EU database for collecting such data would provide enormous benefits for both, market participants in need of comparing their portfolio holdings with the local energy performance and EU bodies in charge of developing further criteria to the Taxonomy. According to the current recommendation, the 15% relative threshold shall be converted into absolute thresholds for energy and carbon emissions, for which collection of data on a large scale will be necessary. A proper baseline and reference level data is key for fostering final investor confidence and avoidance of greenwashing. The development of such database should thus consider the following:
 - The database should allow for **tracking of emission data of single properties** as well as for **calculation of averages** based on certain parameters per country, region or city (presuming that market participants were obliged to establish the energy demand of the relevant reference peer group, cf. our comments in section 6 below).
 - The metric of **PED is so far not clearly defined** at the EU level. This needs to be remedied if PED shall become the reference value for assessing environmental sustainability of buildings.
 - The **absolute thresholds** for energy and carbon emissions to be developed until 2025 should not only **differentiate between countries** (due to diverging weather conditions and building standards), but also **acknowledge differences in energy demand**

³ Morgan Stanley, The EU Taxonomy – your questions answered, Feb 2020.



between specific categories of buildings (residential, office, logistic, hotel and retail). Distinction only between residential and non-residential assets as suggested in the TEG report is too high level for a dedicated performance calculation, e.g. logistic buildings and office buildings would both fall in the non-residential category, but normally show completely different consumption data.

- Creation of a database needs to be accompanied by **regulatory requirements to report the relevant energy data** by commercial and private property owners. Moreover, property owners must be entitled to collect energy consumption data from tenants. In many EU countries, including Germany, tenants are currently not obliged to respond to data requests by property owners.

3. Revenues and CapEx/OpEx as the basis for reference: The technical screening criteria in the annex to the final TEG report include no specification whether an economic activity can be accounted for as Taxonomy-compliant in terms of the respective revenues or only the associated investments or expenses. In many instances, the relevance might be clear from the overall context, e.g. one can assume that in case of production of electricity from hydropower or wind power, the revenues from these activities are relevant. However, in other cases, further clarification is needed. For instance, with regard to the activity 8.2 (building renovation), it is unclear whether in case of renovation measures complying with the reduction target of 30% for the purpose of substantial contribution to climate change mitigation, the renovated property as such or only the renovation expenses can be deemed as sustainable under the Taxonomy.

Our suggestion is therefore to **specify for each economic activity whether it can be counted as environmentally sustainable in terms of its revenues and/or CapEx/OpEx**. Such specification could be included in the technical criteria at Level 2 or provided in a supplemented version of the Taxonomy tools as prepared by the TEG. With regard to the referenced example of building renovation, we see great practical value in acknowledging the entire value of the renovated property as sustainable, at least as a transitional measure. In our view, such clarification would create a strong incentive for renovation of older buildings and hence, would result in significant savings in terms of carbon emissions in the next years.

4. Scope of estimations based on due diligence: As explained earlier, it is clear that fund managers will in many instances not be able to rely solely on corporate disclosures in order to establish compliance of their investments with the Taxonomy criteria. Therefore, use of estimations conducted either in-house by way of due diligence or with the help of ESG rating providers will become elementary.

The TEG acknowledges the problems with assessing compliance in view of limited data and recommends application of due diligence procedures. However, it remains unclear to what extent reliance on due diligence shall be legitimate. The following aspects need further specification in order to provide legal certainty for market participants:

- o Can due diligence be used in order to assess compliance with the technical criteria for significant contribution? Or is due diligence as means for bridging the data gap only meant to be allowed with regard to the DNSH criteria?

In our view, the possibility to apply due diligence for assessing all criteria of environmental sustainability is relevant at least in the phasing-in period of the Taxonomy when material data gaps will still persist. However, it must also be clear that the necessary due diligence



process will be very cumbersome and resource-intensive especially for diversified portfolios encompassing dozens or even hundreds of investment positions and, as a result, will produce additional costs and make environmentally sustainable products less attractive. Therefore, **due diligence can only be an interim solution and availability of objective and verified data is urgently needed** in order to facilitate development of competitive investment products based on the Taxonomy.

- Can asset managers rely on due diligence assessment performed by a third party, i.e. an ESG rating agency? Many small and middle-sized asset managers do not have the resources necessary to perform an extensive in-house due diligence on the Taxonomy or to systematically validate the plausibility of third party assessments. The **possibility to rely on evaluations provided by a recognised service provider** would be a great relief and provide important assistance for the practical application of the Taxonomy.

5. Reasonable disclosures to investors: According to our understanding, disclosures at the level of financial products shall be subject to further specification by way of regulatory technical standards to be developed by the ESAs under the Disclosure Regulation (cf. Article 25 of the Taxonomy Regulation). Consequently, they will not be dealt with by the Delegated Regulation to be prepared by the Commission on the basis of the TEG report.

Nonetheless, the TEG recommends that such disclosures be very detailed. In addition to specifications on transition and enabling activities as foreseen at Level 1, they shall be provided (1) separately for each environmental objective and (2) differentiated further according to whether alignment with the Taxonomy can be demonstrated in full or has been estimated based on due diligence (“potentially aligned activities”). In our opinion, this approach will result in a **very complex disclosure table** that might be desirable in terms of public accountability on the Taxonomy, but will be **of little value for investors and distributors**. Especially for retail investors, such granular reporting on a product’s compliance with the Taxonomy will be very difficult to understand. Investors seeking for Taxonomy-aligned investment opportunities need rather simple, easy-to-grasp information about the overall percentage of environmentally sustainable investments in a portfolio.

Our suggestion for the upcoming RTS to be developed by the ESAs would be therefore:

- **Not to require separate disclosures for each environmental objective as a standard case.** If at all, such differentiated disclosures could be envisaged only for products offered as environmentally sustainable investments under Article 9 Disclosure Regulation, since those products commit to pursue dedicated environmental objectives and should be measured against them,
- **To waive the differentiation between “fully” and “potentially” aligned activities,** since such differentiation is meaningless to investors not familiar with details of the Taxonomy and has the potential to confuse them. If a fund manager applies due diligence in a way consistent with the future regulatory requirements and concludes alignment of a specific economic activity with the Taxonomy criteria, such activity should be treated as aligned without further reservations. The narrative accompanying the quantitative disclosures could make clear, however, that the underlying calculations are in parts not based on reported data and involve some level of uncertainty.

6. Sustainability criteria for real estate activities: BVI members have extensive market experience with the management of real estate funds. In Germany real estate funds, both open- and closed-



ended, are established investment vehicles very popular with retail and institutional investors. The asset under management by German open-ended real estate funds reached EUR 230 bn by January 2020. Closed-ended real estate funds account for additional EUR 27 bn.⁴

According to the feedback by our members, the criteria for significant contribution to climate change mitigation proposed by the TEG for real estate activities are not feasible for commercial properties. Key challenges are the following:

- **Criteria for construction of new buildings (activity 8.1) and acquisition and ownership of new buildings (activity 8.4):** The requirement to undercut the relevant NZEB thresholds for Primary Energy Demand (PED) by at least 20% is too ambitious. As of today, it appears economically not viable to develop buildings which would meet the suggested threshold requirements. Our members see therefore no potential for the development of construction projects for commercial properties with such low carbon emissions in the next years. The additional amount would be better invested in good building management practices or energy management software, and retrofit upgrades once the asset is up-and-running to ensure that the NZEB standards are actually met.

Moreover, the new German building energy law which is planned to be put into force mid of 2020, already requires for energy efficient commercial buildings to use building components which need only 75% of the PED of a reference building with clearly prescribed building components. In order for such newly developed building to become Taxonomy-compliant, we understand that these reduced PED standard need to be undercut by another 20%. Since the approach for commercial buildings differs depending on the national implementation, a blunt reduction by 20% irrespective of referenced national requirements is not appropriate.

Our suggestion is therefore to link the sustainability criteria for newly constructed buildings to the national NZEB thresholds while carefully monitoring the property markets and evaluating the potential for further lowering the thresholds for carbon emissions in the coming years.

- **Criteria for acquisition and ownership of existing buildings (activity 8.4):** The TEG report provides no clarity as to whether the energy performance of the reference pool of buildings required for establishing the 15% threshold will need to be calculated by the industry, i.e. each product provider, or by an EU agency. As highlighted above, reference data for assessing the energy performance of local properties is currently not available in many markets which makes it quite impossible to measure energy efficiency of a building in comparison to the local peer group. In addition, there is no clarity about whether it shall be also up to the product provider to determine the appropriate reference area (a city, a region or a country). Since the outcome of the 15% assessment will be obviously very different depending on the chosen reference area, we deem it necessary to provide for further specification in this regard.

7. Side issue: Taxonomy criteria for the Ecolabel: The current proposal for the EU Ecolabel directly links the investment criteria for equities to the sustainability criteria under the Taxonomy. However, the proposed thresholds for investments in line with the Taxonomy are far too ambitious. In particular, the proposed requirement for equity funds to invest a minimum of 20% of a portfolio in

⁴ Source: German Bundesbank statistics.



companies deriving at least 50% of their revenues from green economic activities results in a very restricted investment universe. According to research performed by one of our members, barely 2% of all companies composing the MSCI World index would potentially qualify as investments under this threshold (based on the current preliminary set of technical criteria). When accounting for the second proposed threshold (minimum 40% of portfolio companies deriving at least 20% of revenues from green economic activities), the investment universe would still be restricted to less than 10% of MSCI World.

Such limited approach would prevent proper diversification and hence, not enable risk-spreading that is generally considered a core feature and benefit of retail funds (cf. Art. 1(2)(a) UCITS Directive). Since the EU Ecolabel shall be dedicated to retail investment products, it is **truly essential that its investment criteria, alongside the accompanying exclusions, are carefully calibrated in order to provide for both, a convincing level of ambition in environmental terms on the one hand and a sufficiently large pool of assets to invest in on the other**. Moreover, they need to be reliably tested in practice, at best on a range of currently offered products, in order to ensure their practicability. In this regard, we hope that the outcomes of the study on a range of existing products conducted on behalf of the Commission will be duly taken into regard in the further regulatory work.

Moreover, the interplay between Taxonomy, NFRD and the proposed rules for the Ecolabel will result in a situation that only funds with an investment focus in the EU will be able to apply for the Ecolabel. As it stands, the Taxonomy Regulation requires only EU-domiciled companies to report on KPIs related to their green economic activities. Therefore, as pointed out above, it is urgently needed to extend the scope of reporting under the Taxonomy and NFRD in general also to non-EU undertakings that are also listed on at least one regulated market in the EU.