Finance Denmark's comments on the draft Taxonomy Delegated Act

FINANCE DENMARK

Memo

December 18, 2020
Doc: FIDA-2060232074-690153-v1
Contact Sandie Wrona

Finance Denmark welcomes the agreement on an EU taxonomy and supports the work of creating a common framework and common standards on sustainable economic activities.

The taxonomy should encourage everyone to improve sustainability irrespective of current levels of sustainability.

In this respect, **we are strongly concerned that the proposed reduction of eligible green buildings would negatively impact the green transition** – regarding both the incentives to buy more energy efficient buildings, the incentives to building renovation and for future green covered bonds markets.

Secondly, **the taxonomy eligibility criteria should be predictable and finite ex ante.** The taxonomy and documentation of technical screening criteria (TSC) should be just as operational and usable for e.g. asset owners, for instance homeowners, and SMEs as for e.g. issuers and investors. For instance, we find it important to enhance the operational usability of TSCs for farming activities, as the agricultural sector is one of the largest emitters of GHGs. Hence, without usability when setting the technical screening criteria (e.g. for farming activities), the political set targets for reducing GHG-emissions will most likely not be reached through the usage of the taxonomy.

Thirdly, it is important to continuously revise and adapt the taxonomy to the fast-moving international work with sustainability. Consequently, **we strongly advocate formally updating the taxonomy at regular intervals and entailing versioning.**

Finally, we believe **there is still a large need and demand for usability guidelines regarding the taxonomy.** The TSC for climate change mitigation and climate change adaptation are very comprehensive, technical and require a lot of expertise and data availability in order to successfully document, that activities are taxonomy compliant. It might be a large hurdle for the green transition of the economy, if using the taxonomy and the documentation of levels of sustainability is getting too difficult or expensive.

In the following we highlight several issues and proposals on how to make the taxonomy work in practice.

Comments on the TSC for climate change mitigation regarding buildings

7.7 Acquisition and ownership of buildings

In addition to the eligibility criteria, which requires at least EPC class A, Finance Denmark supports the Technical Expert Group's (TEG) recommendation, where buildings within the top-15% of the local building stock, in terms of primary energy demand, are eligible. However, it is crucial that 'local building stock' is well defined, e.g. the national stock of residential properties, and that the documentation of 'top-15%' is operational. Therefore, it should be possible to *translate* the 'top-15%' into a clear threshold, e.g. Energy Performance Certificates (EPC). Thus, EPCs should be sufficient documentation for eligibility. Alternatively, to ensure that the criteria can easily and directly be applied, buildings with at least EPC class B should be considered eligible.

Only including buildings with EPC class A, as proposed in the draft Delegated Act, is a substantial change from the recommendation by the TEG. The deviation in the draft Delegated Act from the TEG recommendation reduces the amount of eligible buildings in Denmark by 40%. We believe this is an issue in other European countries as well, as EPC class definitions and distributions of EPC ratings differ a lot across countries. In some member states, buildings with EPC class A constitutes 1% of the building stock.

We believe that the reduction of eligible green buildings and thereby possible green mortgages would have a negative impact on the green transition – both regarding the incentive to buy more energy efficient buildings, building renovation and for future green covered bonds markets. We are worried that the latter will be affected by the reduced eligible green buildings and thereby eligible green mortgages. Issuance of green covered bonds would not be feasible for all issuers, and hence have a negative impact on financing green buildings. Therefore, to be able to foster a green mortgage market, we believe the Commission should follow the TEG recommendation.

<u>Large non-residential buildings</u>

For large non-residential buildings the draft Delegated Act states,

"Where the building is a large non-residential building (with an effective rated output for heating systems, systems for combined space heating and ventilation, air-conditioning systems or systems for combined air-conditioning and ventilation of over 290 kW) it is efficiently operated through energy performance monitoring and assessment. "

We believe the definition of ‘large’ is not at all operational. Measuring size by e.g. m2, would be much more efficient than kW.

Do no significant harm

We fear potential issues regarding documentation of the DNSH criteria and appendix E. It is important all relevant data is available for relevant stakeholders e.g. homeowners and lenders. It would be a large hurdle for the green transition of the economy, if using the taxonomy and the documentation gets too difficult or expensive.

7.2 Renovations of existing buildings

We support the two-fold definition of eligibility

- The building renovation is compliant with the applicable requirements for major renovations.
- Alternatively, it leads to a reduction of primary energy demand (PED) of at least 30%.

Building renovations and improving the energy efficiency of existing buildings is essential for the green transition. As the TEG has stated, renovation rates must be increased in order to set the whole building stock on a net-zero emissions pathway. To successfully increase renovation rates, owners of buildings need to be incentivized to renovate.

It may disincentivize building owners from renovating, if only the amount financing the renovation and not the entire property value is considered eligible, unless the building post-renovation meets the criteria for existing buildings. It is materially impossible for a large share of the building stock to reach an energy efficiency level corresponding to EPC class A. Therefore, most buildings would not be considered green post-renovation. Renovated buildings, which meet the cost-optimal level of energy performance (resulting from e.g. major renovations) should indeed in their entirety be considered eligible.

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. When only the amount financing the specific renovation is considered eligible, the loan is “separated”. From both the perspective of the borrower and the bank, a “separation” of green and “traditional” financing relating to the same property is not feasible. We believe that where costs cannot be practically separated in loans for acquisition and renovation of buildings, acquisition costs should be considered integrally with the eligible renovation costs. Otherwise, renovations of buildings should be categorized as eligible 'transition activities', when at least 50% of the loan relates to energy efficiency measures.

7.1 Construction of new buildings

It follows from national building regulations that newly constructed buildings meet the nearly zero-energy building (NZEB) requirements. The EPBD aims to achieve the Paris climate goals in the building sector and the NZEB definitions are designed accordingly. Therefore, new buildings are already aligned with the Paris climate goals. Consequently, for new buildings to be green it should be sufficient to refer to the NZEB standards.

Furthermore, the definition of NZEB varies heavily in countries across Europe. Thus, for countries with very strict definitions of the NZEB, a requirement of 20% lower energy demand may be hard to obtain for the developer of the building.

It is important that an operational measure, e.g. EPC ratings, should serve as documentation that a building meets the required criteria for construction of new buildings. This would improve the usability of the taxonomy for owners of buildings and other stakeholders.

Comments on the TSC for climate change mitigation regarding agriculture

Typically, farms consist of several types of 'economic activities', e.g. production of non-perennial crops, operating buildings related to the agricultural activities, vehicles, machinery, a private residential house etc. And, typically, new investments in farming is land acquisition or construction/renovation of existing operating buildings. We believe it is important to have a holistic view, when considering whether agricultural activities are taxonomy aligned or not. Operating buildings or vehicles related to the production may or may not be sustainable themselves (cf. the Taxonomy TSC's for such economic activities), however, they can anyway support sustainable agricultural activities. Therefore, we believe that the financing of a farm, including the financing of operating buildings etc., is considered eligible, if the operating farm satisfies the technical criteria for sustainable agricultural activities. Obviously, operating buildings or vehicles may also themselves classifying as taxonomy eligible.

This holistic view is of high importance regarding financing. Financial institutions more often grant loans on farm levels rather than on 'sub activity' levels. In Denmark, Danish mortgage banks – using the unique Danish mortgage credit model - finances around 70% of all loans to the agriculture industry. The model provides inexpensive and consumer friendly loans to Danish borrowers. Mortgage loans to agriculture are typically granted on a farm level, collateralized by property and land, where many parts of the production could be green and other could be considered conventional. Thus, following the above, green loans could be granted to farms, where the production is considered green. And loans granted to non-eligible farms should be considered neutral and not as something undesirable.

Management practices

In the TEG recommendations two different compliance approaches were available for agricultural activities: Deploying management practices and reduction in net GHG emissions obtained by reductions and subtraction of GHGs. We believe it is important to keep the two possibilities. GHG emissions resulting from deploying management practices free of choice contribute to GHG reductions no different than, if reductions resulting from following a predefined list of management practices. Flexibility of choice would without doubt enhance the usability of the taxonomy and to a greater extend animate agricultural companies to use the taxonomy.

<u>We propose the following text to all activities regarding agriculture</u>

"Choice of compliance approach
Based on the information presented in the Farm Sustainability Plan, the agricultural holding selects one of the following criteria to demonstrate compliance with Regulation (EU) 2020/852:

(a) consistently deploy all of the essential management practices listed in Appendix A to this Annex, except those that can be demonstrated to be not applicable to that holding;

(b) consistently deploy management practices that can lead to both of the following:

(i) a 20% reduction of GHG emissions per unit of output within 10 years;

(ii) an increase in land carbon sinks, or, in case of saturation, the maintenance of carbon stocks."

<u>To replace:</u>

"Compliance with essential management practices
To demonstrate that its activities contribute substantially to climate change mitigation and based on the information presented in the Farm Sustainability Plan, the agricultural holding consistently deploys all of the essential management practices

Memo

December 18, 2020
Doc. no. FIDA-2060232074-690153-v1

listed in Appendix A to this Annex, except those that are clearly not applicable to that holding."

Force majeure clause

We suggest adding a force majeure clause as part of the technical screening criteria for agricultural activities. The reason is that extreme weather events can affect yearly emission levels heavily.

<u>We suggest the following wording:</u>

"Emissions and carbon removals that occur due to extraordinary natural disturbances, such as pests and diseases infestations, droughts, wind, storms, which impact the economic activity and cause underperformance, will not result in non-compliance with the criteria laid down in Article 10 of Regulation (EU) 2020/852, provided the verification described in point 5 is consistent with the 2019 Refinement to the 2006 IPCC Guidelines for National Greenhouse Gas on emissions and removals due to natural disturbances and as long as the Farm Sustainability Plan includes adaptation measures to limit risks related to climate change."

Climate baseline

The EU Commission suggests measuring a climate baseline for agricultural activities, i.e. its average performance in terms of GHG emissions and carbon sequestration in the five years prior to the start of the project. It would be almost impossible to conduct a baseline based on data five years back in time. In practice, it would reduce usability, as very few agricultural productions have tracked GHG emission five years back in time.

Usability of the taxonomy

To ensure that the taxonomy works in practice and supports credit market models, we suggest that assets keep the classification of taxonomy aligned throughout the lifetime of the loan financing the asset.

The rationale is to provide certainty and predictability to borrowers, lenders and investors. Providing certainty and predictability is crucial for the transition towards more sustainable finance. Financial assets are directly linked to economic activities, such as real estate activities. The risk of losing taxonomy eligibility due to changes in the taxonomy creates possible barriers to long-term investments.

Loans serving as security for covered bonds may finance green, i.e. taxonomy eligible assets, such as buildings. Whether the building or loan financing the building is green is determined by the version of the taxonomy applicable at the time of granting the loan. We find that 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. In other words, it should be possible to label the proportion of assets in the cover pool that are aligned with the taxonomy.

Taxonomy eligibility criteria should be predictable and finite ex ante. For example, consider a developer, who needs a loan for the construction of a new building. When a bank grants the loan, ex ante the construction, by issuing for instance a green bond, it must be able to rely on a predictable measure regarding the taxonomy. Otherwise, both the developer and the investor incur taxonomy eligibility risk in connection with the green bond funding the loan for the construction.

Finance Denmark is of course available, if there are any questions regarding the comments above.

Kind regards,

Sandie Wrona
Economic consultant
Direct: +45 2616 6461
Mail: swr@fida.dk

Memo

December 18, 2020
Doc. no. FIDA-2060232074-690153-v1