Frankfurt am Main,
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Key messages by BVI[1] in view of the upcoming trilogues on the EU Taxonomy Regulation

Development of a comprehensive Taxonomy on environmentally sustainable investments rightly forms the centrepiece of the EU sustainable finance initiative. While fully supporting this project, we see the real threat that the Taxonomy will become a paper tiger without any relevant impact in terms of reorienting capital flows towards more sustainable investments. This is due to

- high complexity of technical criteria and their application to major asset classes like equities and bonds,
- lack of adequate reporting of verified data by issuers and
- no conceivable prospects to apply the technical criteria also for non-EU investments that account for a significant proportion of the European fund assets.

In order for the Taxonomy to become a useful tool to help investors identify environmentally friendly economic activities, we urge the EU legislators to agree on the following improvements in the pending trilogues:

1. **Define a scope of application adequate to the goals of the Taxonomy:** The Taxonomy shall enable capital markets to identify and respond to investment opportunities that can make a substantial contribution to the EU climate goals and related SDGs. According to the draft technical criteria, this effectively means that the Taxonomy, by being aligned with the EU targets for reducing GHG emissions, (1) looks into singular economic activities and assesses their specific contribution to the EU climate and energy targets and (2) disregards any activities that, albeit in a trajectory to transition, might not pay off for reaching those targets. This is a very narrow approach to determining what is environmentally sustainable. Looking at the current market for sustainable products, this ambitious understanding of sustainability may be appropriate for products that pursue specific sustainability objectives, such as reducing GHG emissions or contributing to climate/energy transition, if these investment objectives are aligned with the relevant EU targets as described above. The Taxonomy should therefore primarily apply to a subset of "sustainable investments with environmental objectives" as a product category defined under the Disclosure Regulation, namely if such objectives are explicitly aligned with the Taxonomy.

   A wider scope of mandatory application in terms of disclosure or even eligible investment assets could harm the currently dynamic development of sustainable finance. Our related concerns are explained in detail in the annex below.

[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 112 members manage assets of more than 3 trillion euros for private investors, insurance companies, pension and retirement schemes, banks, churches and foundations. With a share of 22% in the EU 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.

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BVI recommendations:
- To retain the concept of the EU Taxonomy as a common language applicable to standards and labels for sustainable products and green bonds,
- To apply mandatory disclosures under Article 4 to sustainable investments with environmental objectives that aim at financing environmentally sustainable economic activities in line with the Taxonomy. The definition of "environmentally sustainable investments" in Article 2(1)(a) should include a link to the definition of sustainable investments under the Disclosure Regulation,
- To encourage voluntary Taxonomy-based disclosures by the wider market where appropriate in view of the investment strategies.

2. **Set ambitious but realistic application timeframes:** Application of the Taxonomy shortly after publication of the technical criteria for environmentally sustainable economic activities is pointless for the following reasons:
   - The Taxonomy shall apply only at the level of environmentally sustainable investments without a corresponding reporting obligation for issuers of shares and bonds. Voluntary disclosures by issuers, based on the EU Guidelines on reporting climate-related information, can be assumed at the earliest for the first accounting years starting after finalisation of the relevant technical criteria. In practice this means that first data on the percentage of turnover and/or expenditures attributable to environmentally sustainable economic activities under the Taxonomy can be realistically expected after an implementation period of 18 months.
   - Application of the Taxonomy at an earlier point of time will result in a situation where products offering investments which in fact are environmentally sustainable will be forced to inform the public that the share of their portfolios funding environmentally sustainable economic activities is zero or close to zero simply due to the lack of data to verify compliance of these investments with the Taxonomy. Such outcome will undermine the market's trust and acceptance of the Taxonomy.
   - The sole reliance on voluntary disclosures by issuers will also affect market penetration. Assessment of the technical criteria for environmentally sustainable economic activities cannot be performed without data disclosures by corporates. Such data disclosures, if voluntary, are problematic in general, but would be further impeded if clarity about the technical criteria as the basis for corporate reporting were to be brought about at a later stage.

BVI recommendations:
- To ensure that the entry into force of the Taxonomy is based on a coherent set of rules at Level 1 and 2 allowing for reliable reporting of data,
- To provide for an implementation period of at least 18 months after finalisation of the substantive technical criteria (irrespective of the regulatory endorsement process at Level 2).

3. **Ensure practicability of the technical criteria at Level 2:** We are very concerned about the level of ambition underlying the current suggestions for technical criteria to the Taxonomy. On the basis of the TEG report from June 2019 it must be expected that environmentally sustainable economic activities will account for a very small share of the overall market.[2] A major impediment to classification as environmentally sustainable is the complexity of application of the technical criteria

[2] Analyses of market relevance of the Taxonomy are still in an early stage. According to the evaluation by one of our members on MCSI World Index by using ESG data from multiple sources, the percentage of Taxonomy-aligned activities by the covered companies will be lower than 2.5 percent. Construction of risk diversified portfolios with such limited investment choice will obviously not be possible.

which comprises in particular (1) a positive evaluation of e.g. the absolute thresholds for GHG emissions and (2) verification of the criteria for the “do not significant harm” assessment that also often imply absolute thresholds, e.g. for the recycling quote, or peer group comparisons. This complexity will be further increased if technologies and products used all along the whole industrial value chain needed to be considered in the assessment as requested by the EU Parliament.

In order for the Taxonomy to achieve its goals, the technical criteria must cover a range of economic activities that is sufficiently broad to form an economically expedient investment universe for sustainable investment products. Without prospects for financial returns, environmentally sustainable investments will remain marginal. This means that the level of ambition in terms of environmental targets must be balanced against the level of progress that can be reasonably anticipated from the relevant industry sectors. Moreover, transition of economic activities from carbon intensive to at best carbon neutral must be placed at the centre of the Taxonomy. Companies should be incentivised to implement dedicated decarbonisation strategies by the prospect of classifying for the environmentally sustainable status.

With a Taxonomy wider in scope, as proposed, it could be appropriate to apply the disclosure requirements under Article 4 to a broader range of financial products. This should be considered, however, only after the relevance of the widened technical criteria has been tested on the real economy in order to avoid the negative effects explained in the annex, i.e. in the context of the first review of the Taxonomy framework.

BVI recommendations:

- To widen the scope of technical criteria in order to further embrace economic activities that are in a trajectory towards sustainability
- To carefully balance the general conditions for classifying economic activities as environmentally sustainable, i.e. to ensure that the “do not significant harm” assessment can be performed on a “best effort” basis and that consideration of the entire value chain, while desirable as a good practice, is not a mandatory precondition.

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Annex: Why do we believe that an extension of the Taxonomy to mainstream ESG products would have a negative impact on the development of sustainable finance?

In contrast to sustainable investments under Article 2(17) of the Disclosure Regulation that aim to achieve returns on environmental or social objectives in addition to financial returns, most ESG products offered to the wider market seek to promote sustainability issues by dedicated investment strategies. Moreover, many asset managers incorporate ESG factors into their investment decisions with the aim to better manage ESG risks and to generate sustainable, long-term returns for all investors.[3] Both of the aforementioned approaches are based on ESG data and one or more of the following or similar strategies:

- ESG integration: Integration of material ESG factors into fundamental analysis to enhance investment decision making
- Positive/best-in-class screening: Investment in sectors, companies or projects selected for positive ESG performance relative to industry peers
- Negative/exclusion screening: Negative screening or exclusion
- Norms-based screening: Screening of investments against minimum standards of business practice based on international norms
- Engagement: Encouraging positive change of a company's strategy contributes to its long-term value by using so-called Engagement as strategy[4]

As it stands, the Taxonomy will not work for these "mainstream" ESG products because:

- **These products are managed upon a holistic understanding of sustainability** based on a comprehensive analysis of relevant key performance indicators (KPIs) in relation to environmental, social and governance issues. This requires taking into account (1) the interaction between all elements of sustainability (environmental, social, governance) as well as within these elements (e.g. for environmental: climate, waste prevention, ecosystem, etc.) and (2) the different types of activities, sectors, asset classes etc. as well as strategies which can act in favour of the objective. Sustainable investment strategies such as "best in class" rely on the selection of companies on the basis of such comprehensive analysis of sustainability.

- **These products use sustainability KPIs applicable at the level of the corporate entity or even the relevant industry sector.** This is consistent with the current availability of ESG research. Sustainability KPIs as the basis for risk analysis and investment decisions are often linked to internationally recognised standards of sustainability, especially the UN Sustainable Development Goals (SDGs). Many institutional investors have committed to promote SDGs which they consider as general benchmarks for their investments.

- **These products invest mainly in public equity, sovereign and corporate bonds** in order to ensure broad diversification of risk and daily liquidity. Taxonomy alignment of these investments cannot be assessed without dedicated reporting by issuers. Especially for large companies with multiple business lines, evaluation of the technical criteria at the activity level, such as compliance with specific thresholds for GHG emissions, can be reasonably conducted by the issuer only. Without such reporting, it is quite clear that the Taxonomy will effectively not work for the major

[3] See also PRI, "What is Responsible investment?", https://www.unpri.org/pri/what-is-responsible-investment.
[4] See e.g. EuroSIF SRI Study 2016, p. 22; http://www.eurosif.org/wp-content/uploads/2017/11/SRI-study-2016-LR-.pdf

asset classes represented in investment funds. Application of the Taxonomy to sovereign debt instruments, with the exception of dedicated green bonds, is even generally not foreseen.

- **A major stake of assets is invested outside the EU.** German equity funds invest nearly half of their assets in shares of non-EU undertakings.[5] For these investments, no information on the degree of compliance with the Taxonomy will likely be available. This means that on average nearly half of the assets cannot be reasonably tested against the Taxonomy and as a consequence must not be counted as environmentally sustainable.

Compulsory disclosures about the extent of Taxonomy-aligned investments for “mainstream” ESG products will hence result in a huge majority of products having to admit zero or negligible proportions of such investments. This low-level of adherence will most likely not change with better availability of data because the concept of the Taxonomy as currently envisaged is not consistent with the established market practice described above. Introducing compulsory disclosures might therefore discourage financial market participants from offering dedicated ESG products in order to avoid apparent contradictions in the product set-up and corresponding reputational risks. This applies even more if ESG products were required to invest to a significant extent in Taxonomy-aligned assets. In light of the problems described above, we would expect that in this case most products would be relabeled in order not to be offered as sustainable. Such outcome would be detrimental to the recognition of the Taxonomy as the flagship EU project in the area of sustainable finance and would clearly miss the goals of the EU action plan.

[5] 43.1 percent as of August 2019; source: German Bundesbank statistics.