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The Nordic Securities Association's (NSA) response to the draft delegated regulation on establishing the technical screening criteria for determining the conditions under which an economic activity qualifies as contributing substantially to climate change mitigation or climate change adaptation and for determining whether that economic activity causes no significant harm to any of the other environmental objectives

The NSA welcomes the European Commission's and the Technical Expert Group's (TEG) work in developing a classification system for sustainable investments (taxonomy). We anticipate that the taxonomy brings closer together the different interpretations and understandings of what sustainable economic activity can be and increases the credibility of the sustainable finance market.

The NSA has remained neutral regarding the criteria until now because we are not experts to say what sustainability should mean for other industries. However, the European Commission's delegated act proposes a notable change to the previous TEG's recommendations on buildings' climate mitigation criteria, which impact to sustainable finance market is not consistent with the stated objectives of the EU's Sustainable Finance Action Plan.

1 Need to change the buildings' energy efficiency criteria

Whereas the EU's Sustainable Finance Action Plan in 2018 stated as its objective to "reorient capital flows towards sustainable investments in order to achieve sustainable and inclusive growth", the proposed climate mitigation criteria for existing building stock would in effect mean that in many countries sustainable infrastructure investments or lending would no longer be possible (according to the taxonomy criteria). The Commission proposes that only buildings that have Energy Performance Certificate (EPC) level A could be considered sustainable, but the criteria for granting an EPC level A for buildings varies significantly between the EU Member States. Only about 1% of buildings in Finland have that rating, and there is not a single green bond in Europe that would qualify, if this criterion would become effective. In Denmark, the amount of eligible buildings will be reduced by 40% with the proposed amendment to only include buildings with EPC level A.

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.

We strongly appeal to the European Commission that it restores the TEG's original proposal for buildings' energy efficiency, which is that the top 15% most energy efficient among local stock would be eligible. This criterion would set the same ambition level for different markets, whereas the single EPC level does not, while allowing for the eligibility criteria to tighten over time as buildings reach higher levels of efficiency. Our concrete proposal for change is the following:

Acquisition and ownership of buildings
Description of the activity
Buying real estate and exercising ownership of that real estate.
[…]
For buildings built before 31 December 2020~~, the building has at least Energy Performance Certificate (EPC) class A.~~ ***the calculated performance of the building must be within the top 15% of the local existing stock in terms of operational Primary Energy Demand, expressed as kWh/m2****y.*

Renovations of existing buildings

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.

When a renovated building meets the cost-optimal level of energy performance (resulting from major renovations) not only the CapEx for the renovation should be taxonomy compliant, but also the entire value of the building should be considered eligible. If this is not the case, building owners may be disincentivized from renovating.

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.

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.

2 More precision must be given to the ‘do no significant harm’ (DNSH) criteria for buildings

In the Commission’s delegated act proposal, a building should not be built on arable, crop or forest land (whether covered by trees or not). This kind of vague description could mean that there is no land in the Nordic countries that would be eligible as building site. It needs to be specified what constitutes crop land and what is forest, as the understanding of these concepts can be very different depending on country.

The DNSH criteria on acquisition and ownership of buildings also needs a time frame for determining when enough time has passed since the land use change from crop or forest land to a building site. Without determining such a time frame, we can hardly imagine any buildings that would be taxonomy eligible, as most of the constructed areas have been covered by trees at some point in time.

3 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.