Advisory Report

Steps taken by the federal government on the EU Commission's Action Plan: Financing Sustainable Growth

addressed to the parliamentary Budget Committee

This report comprises the final audit findings issued by the German SAI in accordance with Article 96 para. 4 clause 1 Federal Budget Code. This report may only be disclosed to third parties after its final deliberation in Parliament. A decision on its disclosure is reserved to the German SAI.

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Bonn, den 24. September 2020

Contents

Abbreviations

ECB	European Central Bank
Federal Authority	Federal Financial Supervisory Authority
MSEG	Member State Expert Group
NGO	Non-governmental organisation
Taxonomy Regulation	Regulation of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088
TEG	Technical expert group on sustainable finance
TFEU	Treaty on the Functioning of the European Union

0 Executive summary

In early 2018, the EU Commission published an Action Plan on Financing Sustainable Growth. The Action Plan sets out regulatory proposals to redirect capital flows towards sustainable investments and to reflect the impact of climate change in risk management policies of banks and insurance companies (sustainable finance). In June 2020, the EU legislator adopted a classification system to implement the Action Plan with binding definitions of environmentally sustainable economic activities (taxonomy). The Taxonomy Regulation became effective in July 2020.

Our review focuses on whether or not the federal government acts responsibly in the national interest by financing sustainable growth at domestic and Union level. The purpose of this advisory report is to inform the parliamentary Budget Committee about any risks posed by the taxonomy. The report covers the state of deliberations up to July 2020 and gives due consideration to the comments submitted by the Federal Ministry of Finance (finance ministry) on the draft report.

Our key findings are set down below:

0.1 The taxonomy has been designed by the EU legislator to protect investors from financial products that are wrongfully marketed as environmentally sustainable ("greenwashing"). According to the EU Regulation, financial market participants, such as investment fund managers that market environmentally sustainable assets, shall provide investors with transparent information on the sustainability of such financial products. In addition, they shall use mandatory criteria to assess whether an economic activity or an investment is "sustainable". To enable this assessment, the financial market participants need relevant information from the companies whose financial products they market.

We feel that there is an urgent need to systematically monitor whether and to what extent financial market participants apply the taxonomy properly and comply with applicable transparency rules. In Germany, the Federal Financial Supervisory Authority (Federal Authority) could do this monitoring, for example, through sample checks.

The government promised to work towards effective monitoring of compliance with applicable transparency rules. However, government officials have raised doubts as to whether the Federal Authority had the professional expertise to thoroughly review the taxonomy criteria. We expect the Federal Authority to acquire the professional expertise and skills and the resources needed to perform its task effectively. (No. 3.1)

0.2 Pursuant to the taxonomy, the EU Commission defines the criteria for financial market participants to assess to what extent an economic activity or an investment qualifies as "sustainable". To this end, the EU Commission intends to define appropriate thresholds and limits for carbon emissions or energy consumption etc. that cover a wide variety of economic sectors.

We are concerned that the EU legislator has created large headroom for the EU Commission in implementing the taxonomy. The EU Commission might make use these powers for major industrial policy interventions.

The government stated its commitment to urge at Union level for more effective ways and means to ensure that the member states have a role in deciding on implementation of the taxonomy. We will closely monitor if the government actually manages to effectively engage with other member states and initiate changes in the assessment criteria suggested by the EU Commission, if the government considers this necessary or facts suggest that it is appropriate to do so. (No. 3.2)

0.3 The EU Commission has identified an annual investment gap of €180 billion to achieve the sustainable development goals in the Union. The EU Commission seeks to make the taxonomy an integral part of financial market regulation in order to enhance the reorientation of capital flows. The EU Commission announced steps to complement the taxonomy approach. These proposed steps might include the privileged treatment of sustainable financial investments (green supporting factor) by means of the supervisory regulations of the financial markets, or the amendment of the mandate of the European Central Bank (ECB) towards achieving the sustainability goals.

We wish to make the point that these steps could entail risks for the German economy and the federal budget. Adding new and even competing objectives, such as the sustainability goals, could jeopardise financial market stability because this might dilute the emphasis of risk-based approach used for financial market regulation. We intend to closely monitor further developments and report on our audit findings to the budget legislator as appropriate. (No. 3.3)

0.4 The federal government set up the "Sustainable Finance Committee" composed of experts from the financial sector, industry, civil society and academia and tasked it to develop proposals for a national sustainable finance strategy. In March 2020, the Committee published an interim report. The report presents some 50 recommendations for the government and the financial sector to help enable the "great transformation" of the economic and financial system. The aim is to make Germany a "leading hub for sustainable finance".

We consider it necessary to refine the definition of the Committee's mandate. The government should adopt a structured approach to develop national steps on sustainable finance and interlink them with the above EU initiatives. Based on a sound stocktaking, the government should identify any weaknesses of Germany as a sustainable finance hub and systematically study the possible causes if any. The government should weigh the costs and risks, such as misallocations of economic resources, against the benefits of the steps recommended. The government should also study the proposal made in the interim report to expand disclosure obligations in the taxonomy. This proposal is aimed at German companies. On such a basis, the government will have to make an informed decision on whether or not to take up the recommendations included in the interim report. (Nos 4.1, 4.2 and 4.3)

1 Background

In the year 2015, all EU member states adopted the Paris Agreement on climate change and the United Nations' 2030 Agenda for Sustainable Development. Since that point of time, national governments and the EU have launched initiatives to reorient financial markets towards green economic activities and sustainable investments.

The key purpose is to assess and classify private-sector economic activities against sustainability criteria. Such information is to be made available to financial market participants to facilitate investments in sustainable business branches or in individual green economic projects.[1] The purpose is to implement ecological and social aspects in private-sector finances (sustainable finance) thus helping deliver the transition to a low-carbon and more resource-efficient economy.

At the beginning of 2018, the EU Commission issued an Action Plan on Financing Sustainable Growth (Action Plan).[2] This Action Plan lists regulatory needs at Union and national level:

- reorient capital flows towards green investments,
- urge financial market participants to reflect natural disasters and the impact of climate change in financial risk management and
- foster transparency and long-termism in financial and economic activities.

This has prompted deliberations at Union level regarding several regulatory proposals for climate-related disclosure obligations and benchmarks, and for classifying sustainable economic activities. Those proposals have an impact on the **financial market participants** such as asset managers of risk capital funds, investment managers of insurance companies, investment firms, banking institutions and pension insurance funds. Financial market participants have to comply with applicable requirements. In addition, they use information

1 The concept of investment distinguishes between financial investment and real investment. Financial investments are characterized by investments in shares and bonds. The company can use these financial investments to finance investments in equipment, machinery, etc.

2 Communication of the Commission "Action Plan: Financing Sustainable Growth" of 8 March 2018, document COM(2018) 97. The Action Plan is based on the report of the High-Level Expert Group on Sustainable Finance (of January 2018) commissioned by the EU Commission.

provided in accordance with these requirements to identify options for green investments. Since the beginning of 2019, the federal government has developed a national sustainable finance strategy. The finance ministry has the lead. The purpose is to make Germany a "leading hub for sustainable finance".

We reviewed if the federal government adequately safeguards Germany's sustainable finance interests both at domestic and at Union level. This report covers the developments up to July 2020. The finance ministry commented on the draft of this report. We have given due consideration of the comments in our report.

In Germany, the COVID-19 pandemic will have a considerable impact on economic performance, economic growth and also on public finances. The full impact of the pandemic will materialise with a time lag of several months or even years. Sustainable investments may likely gain in weight in the forthcoming recovery programmes in the European Union since these are also designed to pursue green objectives. Against this background, activities designed to finance sustainable growth will have to be reassessed in the months ahead. Our report highlights current structural shortcomings at Union and national level, but does not aim to provide a reassessment.

2 Significance of the taxonomy

In June 2020, to implement the Action Plan, the EU legislator adopted a "Regulation establishing a framework to facilitate sustainable development investments" (Taxonomy Regulation) effective from the following month[3]. By the year 2021, the EU Commission will have initiated the steps needed to implement the Taxonomy Regulation. From 2022, compulsory use of the taxonomy criteria will be implemented in a stepwise approach for financial market participants.

The core element is an EU-wide classification system (taxonomy) for environmentally sustainable economic activities. The EU legislator intends to adopt

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[3] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment and amending Regulation (EU) 2019/2088, official journal of the EU of 22 June 2020, L 198/13.

separate regulations to incorporate other sustainability objectives in the taxonomy such as social aspects.

The Taxonomy Regulation imposes on financial market participants the duty to advise investors on sustainability risks (rules on transparency) [4]. Financial products contributing to environmental objectives, financial market participants must determine the portion of financial products contributing to environmental objectives in the overall portfolio. As to financial products not pursuing environmental objectives, financial market participants need not apply the green taxonomy for identifying the share of sustainable investments in the overall portfolio. However, they must inform investors that the green taxonomy has not been applied and that significant harm to the sustainable development goals cannot be ruled out.

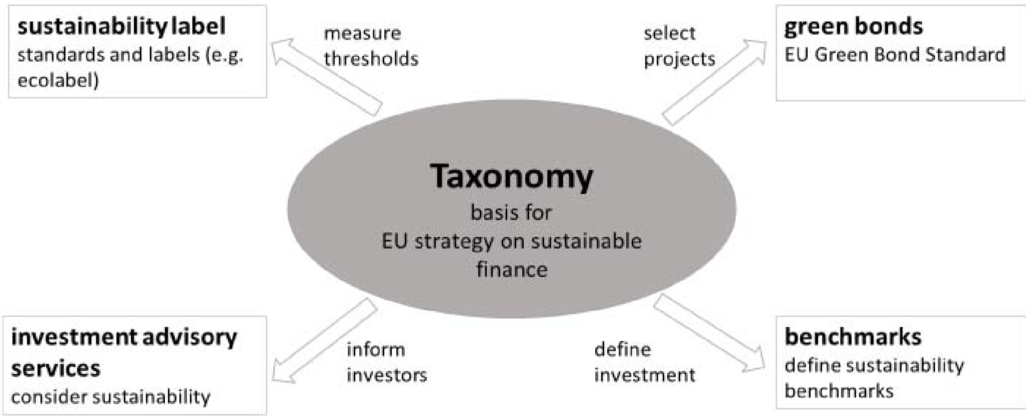
The taxonomy is a framework that the EU and its member states will build on to finance sustainable growth. This also includes green finance standards and labels for sustainable financial products. Such green standards and labels provide specific thresholds for the portion of sustainable economic activities in a financial product to ensure that the financial product can be marketed as a green investment. The respective threshold levels for standards or labels are to be taxonomy-aligned.

The steps proposed for the taxonomy are illustrated in **figure 1** below:

[4] The Taxonomy Regulation sets forth the transparency obligations adopted by the EU legislator in Regulation 2019/2088 as of December 2019.

Figure 1

The taxonomy, a basis for sustainable finance



Source: EU Commission (illustration of the German SAI).

The taxonomy can be applied either to the revenue side or to private-sector investment projects:

- On the revenue side, data needs to be collected on the economic activities underlying the revenues generated by investee companies and to assess if these align with the taxonomy. Such data serve to inform decisions on providing capital for investment in these companies, for example by means of shares. Equity funds and private equity companies are potential purchasers of the shares.
- As to investment projects, the taxonomy concerns individual economic activities and the question as to whether such projects are sustainable in accordance with the criteria set. Such data serve to inform decisions on providing funds to individual projects primarily by means of debt instruments such as bonds. For example, a cement producer could use green bonds to finance investments in production facilities. The prerequisite is that the funds are only invested in taxonomy-aligned projects such as retrofitting or building more climate-friendly production facilities. Pension funds would be a candidate for acquiring green bonds.
  Both the EU Commission and the EU legislator have stated the need for an EU regulation on sustainable finance that is directly applicable in the

member states[5] to

- protect investors from products wrongfully labelled as sustainable (greenwashing),
- facilitate intra-Union financing of environmentally sustainable economic activities, and
- create equal competition for all participants in the European single market (level playing field).

3 Implementation of the taxonomy

3.1 Flawed information and lacking governance on uniform application of the taxonomy

Background

The Taxonomy Regulation defines criteria for determining whether economic activities, in which a financial product invests, qualify as "environmentally sustainable". Such "sustainable economic activities" shall contribute "significantly" to an environmental objective as defined in the Taxonomy Regulation. The objectives stated include e.g. mitigation of and adaptation to climate change, sustainable use and protection of water and marine resources. Such activities shall do no "significant" harm to these environmental objectives.

The EU Commission intends to set detailed technical screening criteria. Such criteria shall be applied by financial market participants to assess under what circumstances an economic activity either "significantly" contributes to or harms an environmental objective.[6] When classifying an economic activity, financial market participants[7] shall compare individual company information with the technical screening criteria.[8]

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5 The relevant legal authority is Article 114 of the Treaty on the Functioning of the European Union (TFEU), harmonisation of national rules regarding the functioning of the internal market.

6 Article 3 of the Taxonomy Regulation makes reference to the technical screening criteria set out in its Articles 10 to 15.

7 The financial market participants may also delegate classifying their economic activities to third parties such as data providers.

8 So far, criteria are in place solely for the environmental objectives of mitigation of and adaptation to climate change.

The following **case study** illustrates how the taxonomy is to be applied to one selected economic activity by a financial market participant such as an investment consultant of a securities company:

Step 1: For a financial product, the investment consultant identifies sustainable economic activities a company is engaged in. The investment consultant identifies an aluminium producer, engaged in only this economic activity.[9]

Step 2: The investment consultant verifies if the aluminium producer significantly contributes to one of the environmental objectives established by the Taxonomy Regulation, for example climate protection. The company must meet technical screening criteria. For the environmental objective of climate protection, these criteria include carbon emissions from aluminium production, energy efficiency and average greenhouse gas emissions of the electric power used for electrolysis (indirect carbon emissions).

In this case study, the aluminium producer must meet the following thresholds set in the technical screening criteria: Greenhouse gas emissions must not exceed 1.514 tonnes of carbon dioxide per tonne of aluminium produced. Electric power consumption of the electrolysis may not exceed 15.29 MWh per tonne of aluminium produced (energy efficiency). Indirect greenhouse gas Step 3 must not exceed 100 g carbon dioxide per kWh.

Step 3: If the aluminium producer meets the technical screening criteria, the investment consultant must check whether the company significantly harms other environmental objectives of the Taxonomy Regulation. This would be the case for aluminium production in case of air pollution by nitrogen oxides and fluorides.

If no company data is available, the investment consultant should rely on a due diligence guide published by the EU Commission.[10]

Step 4: Finally, the Taxonomy Regulation stipulates the duty for the investment consultant to verify if the company meets minimum social standards (prohibition of forced labour, freedom of association, etc.).

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[9] In the case example, the taxonomy is applied to the turnover of the company.

[10] EU Technical expert group on sustainable finance (2019), Taxonomy Technical Report – Financing a sustainable European economy, EU Commission, p. 46 et seq.

Result: If the aluminium producer meets the criteria given in steps 1 to 4 the economic activity qualifies as "sustainable".

If the aluminium producer also engages in other economic activities, the investment consultant needs to review compliance with the classification requirements for each business branch and provide an overall briefing information (reflecting the respective portion of turnover).

Facts established

To be able to adequately classify sustainable economic activities, technical screening criteria and a wide array of business data is needed.

The financial market participants must themselves obtain the data they need for classifying the economic activities (carbon emissions, energy efficiency, etc.). In most of the cases, they need to draw on information that the companies voluntarily make available to them.

However, providing information voluntarily does not apply to large companies of public interest such as capital market-oriented companies, banking institutions and insurance companies with a staff of more than 500 and a balance sheet total of more than € 20 million or an annual turnover of more than € 40 million. Such major companies have the duty to provide information on the sustainability of their economic activities.

According to the Taxonomy Regulation, large companies of public interest must disclose to what extent their turnover and investments or expenditures comply with the green taxonomy.[11] To be able to do so, these companies need sustainability data from their respective subcontractors.

As a result, the Taxonomy Regulation has expanded disclosure obligations for large companies of public interest. So far, such companies have had the duty only to report once a year on environmental, social and staffing matters, the respect of human rights and on fighting corruption and fraud (non-financial

[11] Article 8 of the Taxonomy Regulation.

information).[12] So far, such disclosure obligations have not encompassed detailed data on sustainable investments and turnovers.

At Union level, there are no requirements in place for smaller companies to disclose such information, for example by way of a sustainability report. Differing from Germany, some member states have adopted national disclosure obligations or initiated action to making companies voluntarily commit themselves to provide sustainability reports.

If no business information is available, financial market participants may draw on information held by sustainability rating agencies or external data providers. These parties may possess relevant data from surveys or model-based estimates based on other business characteristics.[13] In its final report, the Technical Expert Group (TEG) that provided advice to the EU Commission on the technical screening criteria, notes with concern that information to be disclosed by companies is not standardised.[14]

The Taxonomy Regulation imposes more rigorous transparency rules on financial market participants.[15] For example, they have to disclose to their clients the environmental objective of the Taxonomy Regulation to which a financial investment contributes. In addition, they are to state what portion of the financial portfolio is spent on economic activities qualified as sustainable under the taxonomy.

Figure 2 below provides an overview of the information needed for carrying out the taxonomy.

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[12] Directive 2014/95/EU (also known as Corporate Social Responsibility Directive, CSR Directive) and Directive 2013/34/EU (also known as Non-Financial Reporting Directive, NFRD). The directives have been translated into national law in 2015 and 2017. In its bill on the translation of the CSR Directive, the federal government estimated the compliance burden for the German economy at one lump-sum of approx. € 35 million and at approx. € 10 million per year. See preparatory documentation for the discussion between the Federal Ministry of Finance and the German Chamber of Industry and Commerce on 27 January 2020.

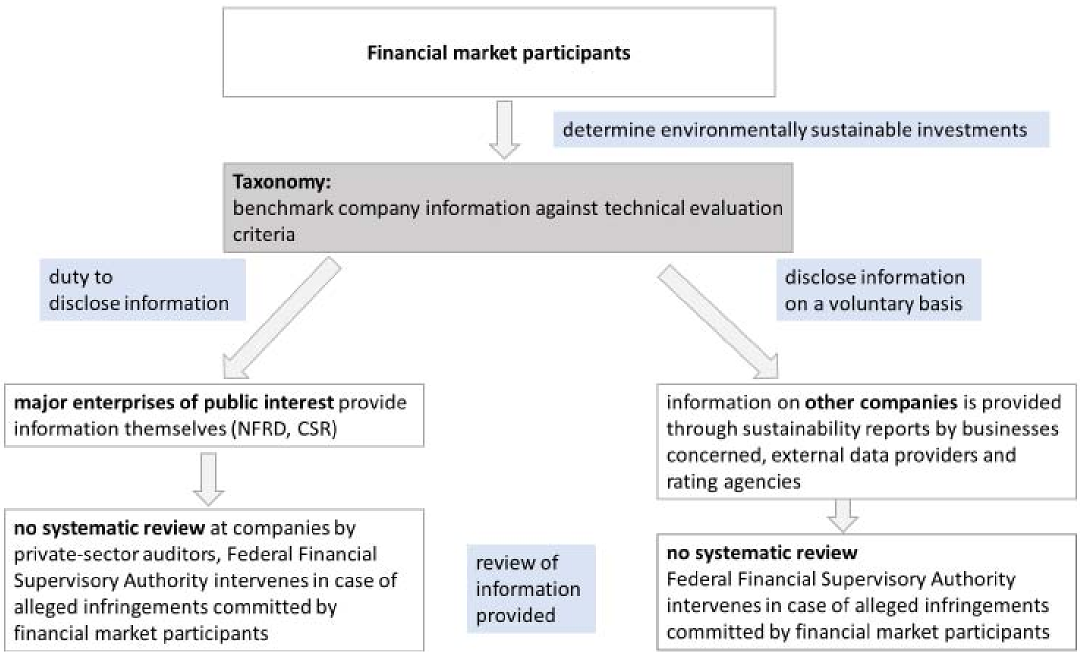
[13] EU Technical expert group on sustainable finance (2019), Taxonomy Technical Report – Financing a sustainable European economy, EU Commission, p. 77 et seq.

[14] EU Technical expert group on sustainable finance (2019), Taxonomy Technical Report – Financing a sustainable European economy, EU Commission, p. 71.

[15] Articles 5 to 7 of the Taxonomy Regulation.

Figure 2

Little information and lacking controls



Sources: Federal Ministry of Finance, EU Commission (illustration of the German SAI).

Pursuant to the Taxonomy Regulation, the member states shall provide adequate governance to ensure compliance with the transparency rules by the financial market participants.[16]

In Germany, the Federal Financial Supervisory Authority is responsible for monitoring compliance with the transparency rules of financial market participants. At the time of our advisory work, the federal government was discussing on how to implement governance structures of the Taxonomy Regulation.

According to information available, the Federal Authority will not be entrusted with systematically checking any information provided by financial market participants. Pursuant to its statutory mandate, the Federal Authority only takes action if there is an alleged violation of supervisory requirements, for example non-compliance with the requirement of fair, clear and non-misleading information.

[16] Articles 21 and 22 of the Taxonomy Regulation

The finance ministry stated that supervision would require a detailed review of the (scientific) technical screening criteria set out in the Taxonomy Regulation, a highly technical task that the Federal Authority could not perform.

Also, it would not be possible to do a material review of compliance with the expanded disclosure obligations of large companies of public interest. Private-sector audit firms in charge of auditing the annual financial statements only have to determine whether the companies submit information in a timely manner.

Conclusions and recommendations

The way the taxonomy is currently structured entails the risk that the Union will not achieve the objectives it set for financing sustainable growth. To classify sustainable economic activities, large amounts of valid, reliable and verifiable data are needed. We found the following major two weaknesses:

- Firstly, data provision places a major organisational burden on the companies.[17] Since for a large number among them this additional effort is a voluntary exercise, many companies might opt for not making such relevant information available.
- Secondly, there is no assurance that relevant information disclosed by the companies has the high quality needed (in terms of standardisation, accuracy and objectivity). This might place a major burden on the financial market participants, as they themselves would have to invest time and effort into preparing the data received to enable analysis.

Against this background, we doubt that financial market participants will proceed with due care to carry out the green taxonomy. The taxonomy implicitly assumes that investors willingly pay more for sustainable financial products than for non-sustainable products. The taxonomy places a heavy burden on financial market participants and companies for collecting and preparing data, although they will likely not be able to make investors shoulder the full cost of this effort (via surcharges, etc.).

In addition, there is no provision in place for Union or national bodies to ensure systematic oversight of whether the taxonomy is adequately

[17] See the above estimations of financial burden for larger companies of public interest in footnote 12.

implemented. This lack gives rise to serious concerns that greenwashing can be effectively prevented (No. 2). To prevent greenwashing the technical screening criteria would have to be applied properly, consistently[18] and fairly to all cases.

The Taxonomy Regulation assumes that the sectors of real and financial economy work together properly and effectively in processing and analysing relevant data. We doubt that this will be the case. In an environment of historically low interest rates and associated favourable financing conditions, the cost of providing information will not be matched by equally high benefits for many companies in the real economy. For this reason, it is rather doubtful that financial market participants will actually obtain data of appropriate quality and quantity from the real economy. It will also remain to be seen if all financial market participants fully comply with the transparency rules.

The taxonomy will only be successful if investors can be effectively protected from greenwashing, because this will help ensure that funding is fully aimed at financing activities that are sustainable and have been duly substantiated. This is the only way to ensure channelling capital flows into sustainable economic activities. If this can be achieved, this will help accomplish the objectives sought by the EU legislator. In any case, limiting the standards compliance checks with taxonomy to alleged violations of governance requirements seems not to be an adequate approach.

Therefore, the government should ensure that implementation of the taxonomy and compliance with its standards is systematically monitored. The government should also adopt a rule providing for sample checks conducted by the Federal Authority. To perform this mission effectively, this body needs professional expertise and technical skills.

3.2 Too little options for EU member states to exert influence

Facts established

The EU Commission determines the technical screening criteria. In this way, the EU Commission has major leeway on whether or not an economic activity is classified as sustainable. The technical screening criteria need to be periodically reviewed and adapted as appropriate to meet evolving requirements. For

[18] Equal criteria must be treated equally and unequal criteria must be treated unequally.

example, committed to the climate protection objective, the Union intends to lower the limit on annual greenhouse gas emissions in the years ahead. So far, TEG has not developed any criteria for some economic sectors. In the course of structural change, more technical screening criteria will need to be defined for newly emerging industries.

The Taxonomy Regulation stipulates that pursuant to Article 290 TFEU, the EU Commission may adapt the technical screening criteria by means of delegated acts.[19] After adopting a delegated act, the European Parliament and the Council may raise any objections within a four-month period. The Council adopts such decisions by a qualified majority vote. Under Article 23 (3) of the Taxation Regulation, each the European Parliament and the Council may at any time revoke its decision to confer to the EU Commission the right to adopt regulations as delegated acts.

In July 2018,[20] the EU Commission set up the group. TEG members are selected experts from the real and financial economy and from non-governmental organisations (NGOs). The EU Commission selected two representatives from Germany to join the TEG working group on taxonomy.

The EU Commission shares information on the major results of TEG's work with a Member State Expert Group (MSEG). The finance ministry represents the federal government in MSEG.

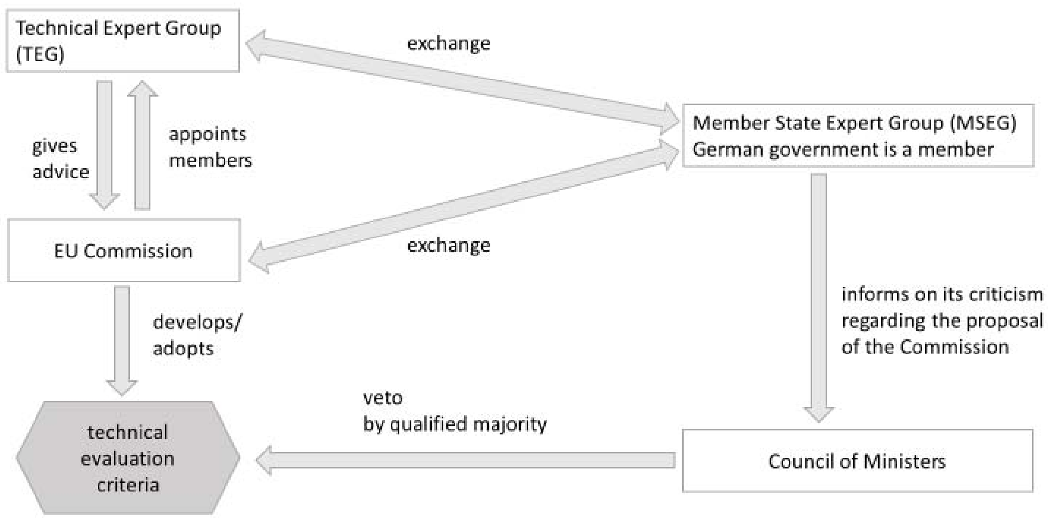
Figure 3 gives an overview of the procedure for defining and adapting the technical screening criteria.

[19] Article 23 (2) of the Taxonomy Regulation.

[20] The TEG has already advised the EU Commission on the classification of sustainable economic activities before the Taxonomy Regulation entered into force.

Figure 3

Too little options for EU member states to exert influence



Source: EU Commission (illustration of the German SAI).

The EU Commission is planning to replace TEG by the "Platform for Sustainable Finance" by autumn 2020. This platform serves to pursue and build on the TEG's work. The EU Commission also intends to designate the platform members.

In deliberations on the Taxonomy Regulation, Germany and other member states have made the point for adopting thresholds to govern the technical screening criteria by means of implementing acts under Article 291 TFEU. Under this procedure, the member states may exert more influence on legal acts. However, these member states were not able to assert their concerns vis-à-vis the EU Commission and the European Parliament.

Two years after becoming effective, the EU Commission intends to conduct a review on how the Taxation Regulation is applied to identify needs for amendment if any (evaluation).[21] Subsequently, such an evaluation is to be carried out every three years.

[21] Article 26 of the Taxonomy Regulation.

Conclusions and recommendations

It is likely that the EU Commission will regularly amend the technical screening criteria from 2020. In this way, the EU Commission would be able to label entire national branches of industry as unsustainable due to their national production characteristics, e.g. the German automotive sector with its focus on internal combustion engines. The federal government would have little influence on such labelling.

We share the concerns raised by the representatives of Germany in the regulatory process, that the EU legislator granted the EU Commission such wide powers in implementing the Taxonomy Regulation. This is not in line with the spirit of Article 290 (1) TFEU. According to this Article, the EU Commission's power to delegate legislation is limited to "non-essential legal acts".[22] In the future, the EU Commission might also use the option to define and modify screening criteria for "sustainable economic activities and investments" for purposes of industrial policy intervention. Thus, the EU Commission would have considerable possibilities to intervene in the member states' domestic policies. If the steps provided for in the Action Plan actually lead to a major rechannelling of capital flows, the taxonomy will gain even more in weight.

In determining the technical screening criteria, highly specialised stakeholders from the real and financial economy and NGOs might also have a say on what economic activities are labelled as green. These stakeholders may use various ways to impact on the design of the technical screening criteria and pursue participatory interests which are not necessarily in line with the common weal.

This is one of the reasons why the federal government has rightly sought to ensure that the Council has a greater say in the legislative process on the Taxation Regulation. Since this effort has not achieved its purpose, it remains to be seen whether the federal government will manage to successfully raise potential objections against individual proposals of the EU Commission.

We advised the federal government to make the point at EU level for more effective influence of the member states on implementing the taxonomy. Article 23 (3) of the Taxonomy Regulation provides for a remedy of last resort. This involves a review of withdrawing authority granted to the EU Commission.

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[22] See Calliess/Ruffert/Ruffert, TFEU Article 290, recital 9 f. (5th edition, 2016)

The finance ministry accepted our recommendation and promised to implement it.

3.3 Risks posed by special treatment of green investments

Facts established

In the Action Plan, the EU Commission estimates that annual capital *expenditure* of €180 billion is needed to achieve the EU sustainability objectives.[23] In the EU Commission's view, better funding options for sustainable economic activities are a major leverage for redirecting capital flows. If the demand for sustainable financial assets increases, this may lead to lower financing costs for the economic activities included in such asset portfolios. In the view of the EU Commission, launching additional economic policy initiatives might help strengthen this leverage.

In the fourth quarter of 2020, the EU Commission intends to identify further EU regulatory needs for sustainable finance. Regulatory proposals include embedding sustainability in the banking sector or in banking regulation and setting up a green rating agency.

In the Action Plan, the EU Commission considers the pros and cons of supporting green supervisory regulations of the financial markets (green supporting factor).[24] As a result of such an approach, banking institutions would not be required to hold as much equity capital for investments in ecological assets as has been the case so far. In addition, members of the EU Commission stated that reviewing the rules governing the Stability and Growth Pact would be of merit to establish new exemption rules, etc. For example, the Commissioner for Economic and Monetary Affairs proposed not to take any longer into account in deficit calculation any investments that the member states make into mitigating climate change.[25]

Recently, voices have been raised to tailor the European Central Bank's monetary policy mandate more closely to sustainable economic

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[23] "Action Plan: Financing Sustainable Growth", loc. cit. p. 3. The European Investment Bank estimates an annual gap of € 270 billion. See Berndt, M. et al (2016), Restoring EU competitiveness, Regional Studies and Roundtables, European Investment Bank, Luxembourg.

[24] "Action Plan: Financing Sustainable Growth", op. cit., p. 5.

[25] See Frankfurter Allgemeine Zeitung, Vom Stabilitätspakt zum Klimapakt?, 6 February 2020.

development:[26]

- Firstly, a sustainability factor is to be included in assessing the financial collateral in ECB refinancing transactions. This would enable a banking institution to obtain a higher refinancing loan for a green bond compared to other collateral for the same market value.
- Secondly, suggestions have been made for offering ECB purchasing programmes tailored to "green" bonds (green quantitative easing).

The federal government is concerned about the non-risk-based equity requirements and a relaxation of rules governing the Stability and Growth Pact. The government holds that a relaxation of capital market regulations for green financial assets might have an adverse impact on the stability of capital markets.[27]

The German Central Bank (Bundesbank) concurs with the view held by the government. It has also spoken out against green purchasing programmes and also against including sustainability as a factor for assessing the financial collateral in ECB refinancing transactions.[28]

Conclusions and recommendations

In our view, it is likely that at Union level further action will be initiated to supplement the taxonomy. The key objectives of the EU Commission's Action Plan could serve as a justification for this approach, such as the objective of channelling capital into green economic activities ("shifting the trillions"). We hold that a number of the steps, that are being publicly discussed, may entail additional risks for the federal budget.

Relaxing the equity capital rules may lead to misallocations in the economy. This might increase the risk of triggering recessions and financial crises.

A relaxation of the Stability and Growth Pact may also add to public deficits and debt ratios of member states raising them to a level beyond today’s all-

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[26] Interim report – The significance of sustainable finance to the great transformation, Sustainable Finance Committee, Berlin, p. 7.

[27] See the reply of the federal government on question 1b of the minor interpellation of the FDP parliamentary group, official records of parliament 19/9813.

[28] See the speech of Jens Weidmann, President of the Bundesbank (2019) at the second Financial Markets Conference of the Bundesbank on “climate change and central banks”.

time highs caused by the fight against the COVID-19 pandemic. This would put an additional burden on public budgets in the Union.

All this taken together entails considerable financial risks that could finally also impact on the federal budget via the European stability mechanism (ESM).[29] We concur with the government's view and warn against lowering equity capital requirements for green investment banking products.

The proposal to take into account a sustainability factor for ECB refinancing operations may entail the risk of equity losses for the ECB. This would make it more likely that debt defaults of banks to the ECB are not hedged by the securities deposited as collateral. This would also affect equity capital held by the Bundesbank and could result in lower totals of distributable profit being transferred to the federal budget. For this reason, the Bundesbank rightly rejects this proposal.[30]

Regarding the asset purchasing programmes, the ECB needs to adhere to the principle of market neutrality. This means that the composition of the bond portfolio acquired by the ECB has to reflect the broad market[31]. Placing a greater preference on green bonds in asset purchasing programmes would violate this principle. On top of that, the risks linked to such purchase programmes could materialise in equity capital losses for the ECB.

We concur with the federal government and the Bundesbank in that steps supporting the taxonomy should not actively intervene in market processes. The steps presented have the potential of jeopardising the stability of the financial market system. Furthermore, no assurance can be provided that such steps actually lead to an (environmentally) sustainable economy.

As to emissions trading, for example, a market mechanism is in place to provide for price adjustments in line with the targets set for reducing greenhouse gas emissions. So far, it has not been substantiated if and how the green taxonomy can provide added value to the system in place.

We will monitor developments at Union and national level and report on our audit findings to the budget legislator as appropriate.

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29 For further information, see the Advisory report of the German SAI on the risks of a reform of the European Stability Mechanism (ESM) for the federal budget, May 2019.

30 See the speech of Jens Weidmann, President of the Bundesbank (2019) at the second Financial Markets Conference of the Bundesbank on “climate change and central banks”.

31 Article 127 TFEU.

4 Nationale sustainable finance strategy

4.1 Recommendations made by the Sustainable Finance Committee

The EU Commission holds the view that coordinated efforts need to be made across the Union to build up a sustainable finance system. In the Action Plan, the EU Commission calls upon the member states to take steps to foster national transformation.[32] The purpose of this is to embed the Union initiatives in a coherent overall approach.

Since the beginning of the year 2019, the German government has taken steps to establish a national sustainable finance strategy. The finance ministry leads the work underway and works closely together with the Federal Ministry for the Environment, Nature Conservation and Nuclear Safety (environment ministry) and the Federal Ministry for Economic Affairs and Energy.

In developing the sustainable finance strategy, the government relies on external expertise. In June 2019, the government set up a Sustainable Finance Committee. The finance and the environment ministries staffed the Committee with representatives they selected from the financial sector, the real economy, academia and NGOs (see No. 1). The Committee members are not subject to the federal government's instructions.

On 5 March 2020, the Committee published an interim report on the status of developing a sustainable finance strategy. This report sets out some 50 recommendations to act for the federal government and the financial sector to shape the "great transformation" (quotation) of the economic and financial systems. **Figure 4** provides an overview of the recommendations included in the interim report issued by the Committee.

[32] Information on the Action Plan see above No. 1.

Figure 4

Wide recommendations of the Sustainable Finance Committee

Source: Sustainable Finance Committee (illustration of the German SAI).

Associations and other stakeholders had commented on the draft by May 2020.[33] The Committee intends to give consideration to the comments received from associations and publish the final report on a national sustainable finance strategy by the beginning of 2021.[34]

4.2 Need for actions proposed not substantiated

Facts established

The government tasked the Committee to develop recommendations to help make Germany "a leading hub for sustainable finance". The government has failed to clearly define the meaning of this term. Nor has the government stated the criteria to be met by Germany to actually become a leading hub for sustainable finance. The government holds the view that such a definition of targets would have impaired creative thinking within the Committee.

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33 See overview: „Konsultation SFB Zwischenbericht - Die wichtigsten Ergebnisse und Schwerpunkte der Rückmeldungen", retrieved on 7 August 2020 under https://sustainable-finance-beirat.de/konsultation.

34 The date scheduled for October 2020 has been postponed.

According to the interim report, sustainable investments should preferably include systematic market interventions such as taxes or subsidies.[35] This might also include upscaling support for renewable energies or for electric vehicles.

In the interim report, the Committee has not stated what is the footing for its recommendations. For example, information sources for empirical analyses or surveys are lacking. We found that the Committee has based its statements on a non-representative market survey dating from 2018. This survey relies on information on obstacles to making Germany a hub for sustainable finance.[36] Also, the interim report makes reference to selected member states that have in place a national sustainable finance strategy with sustainability-related disclosure and reporting obligations such as France and the Netherlands.[37]

Conclusions and recommendations

Until the government has specified the features of a leading hub for sustainable finance, the government will not be in a position to make a reliable statement on the success of any steps taken as part of the sustainable finance strategy. Neither specific targets nor measurable yardsticks are in place for this purpose.[38] In our view, the government's justification that it did not intend to impair creative thinking is not convincing. The strategic shaping and coordination of policy areas (in this case a leading hub for sustainable finance) is a sovereign duty, that the government must not delegate to any stakeholders.[39]

The sustainable finance strategy also needs to be complemented by the related action required. For this purpose, the Committee should have had to identify weaknesses of Germany as a hub for sustainable finance (if any) and specify their possible causes. No solid stocktaking is available in the interim report. In addition, it is not appropriate only to describe the legal situation or

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35 See interim report, loc. cit., p. 44. Market interventions are measures that distort the market prices, e.g. by taxation or subsidies (direct price effects due to higher or lower prices) or by public investments which increase the supply of and the demand for sustainable investments (indirect price effect by changing the quantity).

36 See "Shaping the Future – Green and Sustainable Finance in Germany", Green and Sustainable Finance Cluster Germany, Frankfurt, p. 12, footnote 3.

37 Interim report, loc. cit. p. 4 and 34.

38 On the importance of programme results audits on sustainable measures, see the final management letter of the German SAI on the domestic progress towards the sustainability objectives of the United Nations 2030 Agenda -Ref. I 7 (I 1) - 2018 - 0911 of 13. August 2019.

39 Article 3 para. 1 of the Joint Rules of Procedure of the Federal Ministries.

list alternative options in other selected EU member states. This mere fact does not constitute a compelling reason for Germany to adopt additional sustainability-related disclosure and reporting duties.

On top of that, the interim report recommends several market interventions without reflecting on the added value (if any). The report does not or not properly present costs and risks associated with interventions, such as any economic misallocations.

We wish to make the point that there is a high likelihood that those market participants that benefit from public subsidies in selected economic areas have a major interest in perpetuating such a market intervention. Once such a market intervention mechanism has become established, it is a rather difficult exercise to second-guess its benefits or even to abolish it altogether.[40] Against this background, we are very concerned about the Committee's positive attitude towards such market interventions as expressed in the interim report.

We recommend to the government defining quantifiable targets that can be measured by means of indicators.[41] We consider the following targets as possible features of a hub for sustainable finance:

- The growing demand for sustainable finance assets is met. To measure this target, data needs to be collected on the market volume or market share of sustainable finance products in Germany.
- The classification of green finance products in the taxonomy is implemented in an effective way. To measure target achievement, satisfaction surveys on the implementation of the taxonomy could be conducted among financial market participants.
- Standardised high-quality data to measure sustainability risks posed to financial market stability are available at little effort. This target could, for example, be measured by the Bundesbank that relies on such data to enhance its analyses of financial market stability.

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[40] See German Council of Economic Experts (2016), Energy transition: Shifting towards a global climate policy, German Council of Economic Experts, Wiesbaden, 2016/17 Annual Report, chapter 11, p. 457.

[41] Indicators are variables which can be determined empirically (quantitatively or qualitatively) by a survey or by monitoring. They illustrate the development of a target figure which cannot directly monitored.

4.3 Doubts on the benefits of strengthened disclosure obligations

Facts established

According to Article 8 of the Taxonomy Regulation, major publicly traded companies such as banking and insurance institutions have the duty to disclose the extent to which their economic activities are sustainable (see No. 3.1).

This applies to businesses with

- a company statute model such as stock corporations, limited partnerships or incorporated private companies,
- more than 500 employees and
- a balance sheet total of more than € 20 million or an annual turnover of more than € 40 million.

Such companies shall specify the share of their turnover and of their "overall investments and/or expenditures" that are "associated with" economic activities that are considered "sustainable" in the taxonomy. It is not mandatory for other enterprises to align reporting in their annual financial statements to the taxonomy.

In the interim report, the Committee suggests expanding the disclosure obligations for German companies. According to the report, in the future, small and medium enterprises in Germany shall also disclose information on the sustainability of their economic activities.

For Germany to become a hub for sustainable finance, the Committee has also identified the need for developing more sustainability factors. For example, businesses are to exceed the requirements set by the Taxonomy Regulation and report on what possible impacts the climate change will have on their business model or what impact the business itself has on the environment and society at large.[42]

In our audit mission, we did not find any evidence on that the federal government or the Committee have carried out a cost-benefit-analysis to complement the interim report. It will be only as part of further deliberations on a national sustainable finance strategy, that government intends to study more closely the impact of the recommendations made by the Committee and ensure the coherence of this approach with rules at Union level.

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[42] See interim report, loc. cit., p. 34 et seq.

Conclusions and recommendations

The recommendation included in the interim report to impose the obligation on small and medium enterprises to disclose the sustainability of the turnovers, investments and expenditures, could impede the international competitiveness of German businesses. Such an obligation would impose a high administrative burden. In addition, no data is available on whether the costs are matched by an adequate level of benefits.

We would have expected the interim report to contain a cost-benefit-analysis to inform decisions before prematurely recommending disclosure obligations for small and medium enterprises in Germany. It remains to be seen whether the expected benefits for enterprises actually exceed the cost for implementing the recommendations. To avoid competitive distortions, such a step (if any) should be taken at Union level and apply to all member states.

The government should promptly analyse what information is needed to implement the Taxonomy Regulation effectively. Such an analysis should also include business data on the use of electric power or on greenhouse gas emissions that can be benchmarked against the technical screening criteria. More information beyond such data should be subject to reasoned justifications for their impact on the objective of a sustainable real and financial economy.

Dr. Mähring Demir