

# SUSTAINABLE FINANCE: EXPECTED IMPACTS OF THE CURRENT EU LEGISLATIVE PROPOSALS

The yearly investment gap to cover the targets defined by the EU commission to meet climate and energy targets for 2030 in line with the UN 2030 Agenda, the Sustainable Development Goals and the Paris Agreement, is estimated to be between € 175 to 290 billion. To honour those investments a specific policy framework is needed to incentivise the private sector which will have to play an important role.

## 1. The tasks of the Technical Expert Group

In this perspective, a Technical Expert Group (TEG) was established in June 2018 to assist the Commission notably in the development of screening criteria helping to sort out economic activities in an EU taxonomy; and minimum standards for the methodology of «low carbon» and «positive carbon impact» indices.

Later on, a Platform on Sustainable Finance is expected to advise the Commission on: (i) further developing the taxonomy (including the identification of activities - and their technical screening criteria - delivering on the other environmental objectives) and (ii) updating the taxonomy to cater for market and technological developments.

Therefore one key subgroup of the TEG, is related to the taxonomy the objectives of which are to:

- Defragment capital markets in the EU, by avoiding heterogeneous taxonomies among different Member States and financial institutions;
- Protect investors by increasing transparency and avoiding green-washing;
- Provide projects sponsors and investors with appropriate signals and more certainty.

According to the G20 Green Finance Synthesis Report (2016): “In many countries and markets, the lack of clarity as to what constitutes green financial activities and products (such as green loans and green bonds) can be an obstacle for investors, companies and banks seeking to identify opportunities for green investment.” Furthermore, a taxonomy should make it easier and less costly to raise capital and further channel savings toward energy efficiency investments.

This should also create a common ground for the other envisaged policy tools (benchmarks, disclosure obligations...) expected to foster green finance and mitigate non-sustainability risks notably climate related ones.

Indeed, the forthcoming taxonomy should further enhance transparency, consistency and comparability, to the benefit of EU Green Bond standards. Similarly, EU low carbon and positive carbon impact benchmarks, which require defining how emission savings are calculated, how to choose baseline scenarios and what category of emissions must be encompassed, have to be consistent with the defined taxonomy as should also be the EU disclosure framework on climate-related information. More generally in addition to those related to capital markets, the benefits of a common taxonomy should extend to project evaluation, lending practices and risk management.

## 2. The task of the subgroup on taxonomy is to:

- Determine a list of environmentally sustainable economic activities i.e. activities contributing substantially to a given environmental objective - starting with climate change mitigation and adaptation - and without any significantly negative contribution to any other environmental objective;
- Assess the environmental, economic and financial market impacts of the envisaged taxonomy.

### 2.1. Mitigation taxonomy

The TEG has identified six macro-sectors for climate-change mitigation based on GHG emissions. Within these sectors, as of December 2018, certain activities are under more detailed consideration for climate change mitigation<sup>1</sup>:

- Afforestation, reforestation and forest rehabilitation/restoration;
- Manufacturing, including energy and resource efficiency as well as the manufacturing of renewable energy equipment, low carbon transport vehicles, equipment and infrastructure, or energy efficiency equipment for buildings;
- Energy Production techniques (Geothermal, Hydro, Solar, Wind, Ocean);
- Passenger and Freight Rail Transport and interurban scheduled road transport services for passengers, as well as light passenger cars and commercial vehicles and freight transport services by road;
- Construction and renovation of buildings (residential and non-residential).

<sup>1</sup> Mitigation refers to actions taken to lower the concentration of greenhouse gasses in the atmosphere and thereby reduce the extent to which the global climate system changes.

Certain of these activities were identified as providing a substantial carbon sequestration opportunity. Among mining activities, extracting certain materials has been identified as essential to the low carbon transition. Certain manufacturing activities are also acknowledged as being key to providing components to enable emission reductions in other sectors. Among energy supply activities the TEG initially focused on renewable energy generation. Two enabling sectors<sup>2</sup> are also being considered.

### 2.2. In addition, an adaptation<sup>3</sup> taxonomy is being developed regarding economic activities for adaptation to climate change

A two-step process is proposed to demonstrate that an economic activity contributes to a substantial reduction, of specific diverse negative effects of climate change, bearing in mind that adaptation activities may target an asset and/or benefit a wider system beyond a specific economic activity/asset.

The first step consists of assessing the targeted negative effects of a climate change, while the second step seeks to demonstrate how economic activity will address or prevent these identified negative effects.

The adaptation methodology is supported by four principles:

- An economic-activity has to address material physical climate risks;
- Any adaptation economic-activity should avoid maladaptation;
- Any adaptation economic-activity must benefit from a monitoring system in order to measure progress;
- Any adaptation economic-activity has also to be part of a wider strategy that promotes long-term climate resilience.

These principles are reflected in a set of criteria, related metrics and possibly compliance thresholds, which are specific to each activity. Number of options to set these criteria have been proposed in the consultation.

### 3. The discussed approach raises concerns

Cicero - Shades of Green<sup>4</sup> expressed in January 2019 some concern about the implications of the initial design of this taxonomy, which, it feared, might discourage the issuers of green bonds from heading further in a greener direction. Consequently, it advised that the taxonomy should be used as a guidance rather than a standard. Indeed, explicitly-justified thresholds, adopted on a voluntary basis and combined with transparency on reporting, would sufficiently guide the market without setting up a binary compliance system. In particular, the concern is that binary thresholds might discourage still modest initial

investments that will be deepened over time, although they need to be made soon. Furthermore, estimating avoided emissions might be considered as unrealistic, controversial or too complex, while the target of the taxonomy should be to encourage all investments to be as green as possible.

Furthermore, the consultancy considered that the proposed taxonomy approach does not currently provide an integrated framework for informing investors about climate and environmental risks since at present, mitigation and adaptation activities are considered separately.

This could result in missed opportunities for infrastructure investments which should be designed to integrate both low emissions and resiliency to extreme weather changes events. Furthermore, energy efficiency should not be the only focus for green bond issuers in particular in sectors already mainly relying on renewable energy.

Finally, one essential issue is that approximately 67% of the green bonds that Cicero has reviewed according to its own framework, would probably not comply with the preliminary EU taxonomy.

To address these issues, Cicero has put forward its “Shades of Green” methodology which combines mitigation and adaptation, and rates green bonds on a scale to indicate the relative level of climate risk, rather than a threshold-based approach.

Indeed, since there are now around \$1.5tr of bonds outstanding, according to numbers published by the Climate Bonds Initiative (CBI), common sense for the EC’s package is to be based on highly pragmatic, market-driven proposals that seek in particular to link the sustainability qualification of an investment with concrete objectives. They also favour open-ended approaches to the eligibility of activities since mitigation and adaptation are context- and location-specific.

However, the EIB insists on the fact that the EC classification also needs to be based on the contribution of economic activities to clearly defined objectives supporting the UN 2030 agenda (SDGs) and the Paris Agreement. It also insists in this perspective on the need to establish impact indicators, in line with the approach proposed by the G20 Green Finance Study Group in 2016, and also to specify significance-thresholds for clear reference.

### 4. Standards comparable at the international level are necessary

International consensus around comparable standards is also necessary. International issuances require the translation of the EU issuers’ classification standard in the non-EU investors’ classification standards, and vice versa.

<sup>2</sup> Information and communication and professional, scientific and technical activities.

<sup>3</sup> Adaptation in the field of climate change, refers to actions taken to reduce the negative consequences of changes in the climate.

<sup>4</sup> CICERO Shades of Green is a provider of Second Opinions on green bond frameworks, drawing on competence from CICERO Center for International Climate Research <https://static1.squarespace.com/static/5bc5b31a7788975c96763ea7/t/5c5040dfc2241bf977863de3/1548763359811/CICERO+GREEN+taxonomy+comments+final.pdf>

In this respect an important task for the legislator is also to give a global dimension to the forthcoming EU standard. In its preface to the EIB and the GFC co-authored white paper, the China Green Finance Committee insists on the necessity of a common language for green bonds due to a maturing domestic green bond market which is experiencing a rapid expansion of cross-border issuance and investing as well. This is happening in a context where actually, the People's Bank of China (PBOC) and six other ministries jointly issued the 'Guidelines for Establishing the Green Financial System', providing a comprehensive and overarching framework for developing green finance.

In this respect the EIB is contributing to an initiative developed in partnership with China's Green Finance Committee (GFC), which was set up in 2015 by the People's Bank of China (PBoC) to enhance transparency and comparability in the green bond market. In 2017, the EIB and the GFC co-authored a white paper mapping out common principles for climate mitigation finance contributing to the emergence of a global taxonomy for the use of proceeds. And an interim report has been published in a second EIB-GFC white paper at COP 24 in Katowice.

The pragmatic objective of the CGFC-EIB ongoing work on taxonomy is the establishment of a reference platform that facilitates China's green bond issuance in the EU and EU's green bond issuance in China. Phase III of the CGFC-EIB joint research project develops a clear framework for the mutual translation of China and EU climate mitigation standards by COP25.

#### **5. Low carbon and positive carbon impact indices**

ISDA and AFME provided a number of comments on the detail of a proposed methodology, including the view that benchmark administrators should be able to obtain low carbon impact and positive carbon impact benchmark designation on an optional basis at this stage, and should not be mandatorily required to do so (if falling within the low carbon impact or positive carbon impact definitions in the proposal).

This would allow administrators to adapt and innovate as our understanding and technology in this area develops. They also believed that the inclusion of 'scope 3' emissions should be optional at this stage given the limitations regarding the data behind such a criterion.

ISDA and AFME also noted that the proposal as drafted would come into force and apply from the day following publication in the Official Journal (OJ) of the EU. They stressed that it would be more realistic and proportionate to define a transition period for complying. ■