Implementing the EU sustainable taxonomy

Emma Navarro

Vice-President,
European Investment Bank (EIB)

Implementing the EU taxonomy

To tackle the climate and environmental crises, the financial system and sustainability will need to be closely connected. Only integrating ESG considerations into investment decision-making, sustainable investments could be unlocked at the scale required to support the transition to a climate neutral society. For this to happen, we must start with a common understanding on what is a sustainable investment.

Having a common language in place is key to give clarity to investors on what is a green investment and avoid "greenwashing" in the market.

This is precisely the goal of the EU Taxonomy on sustainable activities. The taxonomy establishes the conditions and framework to create a unified classification system on what can be considered an environmentally sustainable economic activity. The aim is to develop a list of such activities for the purpose of investment, building around six environmental objectives and based on technical screening criteria. Eligible activities will need to make a significant contribution to one or more of these goals, avoiding significant harm to the others. The list of activities will be developed over time starting with two first environmental objectives, climate change mitigation and adaptation.

The taxonomy will be open to change, to align the classification to market trends and regulatory changes. Transparency and standardization will also be fostered. The regulation on the taxonomy introduces new disclosure obligations for financial market participants that offers financial products. More than 6000 large companies and groups across the EU will be required to comply with its disclosure requirements.

On the other hand, the taxonomy provides green definitions that will be used in the upcoming EU Green Bond Standard and InvestEU regulation. Beyond that, it will also play a major role in promoting consistent and transparent definitions of green loans, green mortgages and other green financial products.

As the EU climate bank, the European Investment Bank has been technically supporting the development of the Taxonomy, through the Technical Expert Group (TEG) set up in 2018. After the final report of the TEG published last March, the EIB will continue to help with expansion of the taxonomy to the other environmental objectives and to provide technical support to Commission towards the publication of the legislation by the end of 2021.

The EU taxonomy will be the most comprehensive guideline of sustainable activities ever developed and is likely to set a global benchmark. One of the key outlets for this taxonomy is the International Platform on Sustainable Finance, of which the EIB is also a supporting partner.

Launched in October 2019 by a group of countries that emit almost half of the world's greenhouse gas, the platform will seek international coordination and information exchange on different sustainable finance initiatives that will help identify barriers and opportunities. It will give an opportunity to promote the EU taxonomy framework.

> *The taxonomy represents a major step for Europe to meet its energy and climate goals.*

A key challenge in the implementation of the taxonomy is data. The development of sound methodologies, metrics, and data collection and reporting systems will be critical for the success of the taxonomy. The TEG has been exploring how to address these challenges, giving guidance on the use of data to different types of users of the classification.

The taxonomy represents a major step for Europe to meet its energy and climate goals. When investors have better information about their climate impact, they can make better decisions. This increases the private sector's investments in low-carbon projects and in climate change adaptation.

That is how we will finance the transition to a green, climate-resilient future. ●

Natalie Westerbarkey

Head of EU Public Policy, Fidelity International

Implementing the EU sustainable taxonomy: a race against time

The EU taxonomy report published on 9 March 2020 is a major milestone providing guidance to investors, companies and issuers on the definition of environmentally green, enabling and transitioning economic activities.

It also introduces specific social and governance criteria, as activities can only be deemed sustainable if they comply with 'minimum safeguards' such as the OECD Guidelines for Multinational Enterprises, the UN Guiding Principles for Business and Human Rights, and the International Labour Organisation's (ILO) declaration on Fundamental Rights and Principles at Work.

Of course, countries can apply more stringent or additional environmental, social and governance (ESG) requirements through local climate, labour or other laws.

There is a systemic nexus between climate change, global disease, social and governance aspects. The pandemic crisis amplifies that ESG criteria are interdependent, exponential and of global systemic relevance. According to the UN, large scale climate migration is expected to increase the frequency and severity of disease outbreaks.

It impacts global medical supply, food security, supply chains, employee rights, economies and financial markets. The WHO suggests that changes in infectious disease transmission patterns are a major consequence of climate change.

The EU taxonomy therefore represents an indispensable policy tool which collectively guides corporates, investors and sovereigns in defining those activities that are environmentally, socially and from a governance perspective sustainable. It has the potential to promote a true shift towards responsible capitalism, if corporates disclose ESG data or roadmap, so to attract more investments. Fidelity has launched a proprietary ESG rating tool to capture that data and engage with corporates and investor clients.

Investor client choices remains the main driver. From a financial perspective ESG assets seemingly show greater resilience during down turns, creating an incentive for investors who look for downside protection. Raising further awareness through investor education will be critical right now.

A timely implementation of the EU sustainable taxonomy is crucial to prevent irreversible environmental damage and future outbreaks to protect the people and planet. Many countries and the European Parliament acting on behalf of almost half a billion EU citizens have only recently declared a climate emergency.

Implementing the EU taxonomy creates opportunities as sustainable finance goes beyond just green investments related to energy and transport. The wider European Green Deal remains vital. It stretches from agriculture, foods, manufacturing, real estate to large infrastructure projects including the health care sector and medicine innovation projects co-financed by the European Investment Bank.

A global approach is indispensable to achieve a meaningful impact. The EU launched an important International Platform on Sustainable Finance (IPSF) which already includes some of the largest countries. In parallel, the G20/OECD are working with asset managers on a sustainable infrastructure report to be presented to G20 Finance Ministers mid 2020.

A global rapid response on sustainable finance is required to limit the catastrophic impact and the optimal solution is reached through international solidarity. ●

Ingrid Holmes

Director, Head of Policy & Advocacy,
Federated Hermes – International

EU sustainable taxonomy: a good start but only part of the jigsaw puzzle

The EU's sustainable taxonomy has attracted criticism for reflecting only a narrow set of economic activities being undertaken by an even narrower slice of financial markets. However, such criticism is misplaced. The taxonomy is a work in progress and reflects only one piece of the broader financial market reforms put in place as part of the EU's Sustainable Finance Action Plan.

The taxonomy is needed because many financial market participants do not understand what sustainability, or 'net zero,' means in the context of specific climate-related economic transition. Such a lack of understanding is equally true amongst many corporates and policy makers too. Academics have referred ▶

to the taxonomy as a 'boundary object': common information that can span a range of intersecting communities. In this case investors, corporates and policymakers. It is facilitating a common understanding of the characteristics our future 'deep green' economy needs if we are to make a success of the Paris Agreement on Climate Change.

Developed in consultation with a broad-based group of experts, the taxonomy is an impressive piece of work. It not only defines in detail our 'deep green' future, it also helps users of the taxonomy to think through how they need to balance the different facets of a truly sustainable economy.

The EU taxonomy should be embraced by all governments/regulators as a basis for a global conversation and serve as the basis for an emergent set of integrated sustainability expectations. Continued development of the EU taxonomy should be supported, free from political pressure. The EU taxonomy represents expert views on what European economies need to achieve to be considered, truly sustainable. It needs to be outcome based – rather than reflecting the different transition pathways each member state might take.

> *The taxonomy is a work in progress and reflects only one piece of the broader financial market reforms*

The next step in the taxonomy evolution will be its adoption and implementation by the investment community, where it will serve as a new reporting tool for clients to better understand how aligned, or not, different products and firms are to the taxonomy. The decision by the European Commission to link the taxonomy to the Non-Financial Reporting Directive reporting requirements was critical to ensure necessary data flows, as one of the challenges the investment community would have faced is that companies currently are not required to report on their economic activities at the level of detail envisaged by the taxonomy.

There is anecdotal evidence real economy firms affected by the climate transition are already using the taxonomy to consider forward capital expenditure planning – and this can only be a good thing. The window of opportunity to manage climate change is less than a decade, and it is critical that both companies looking to access capital markets, and investors looking to encourage sustainable investments, consider whether their forward operations and strategies map to the taxonomy.

Takanori Sazaki

Regional Executive for EMEA, Mitsubishi UFJ Financial Group (MUFG)

The road to responsible decarbonised banking

The end goal of the energy transition to a net zero world is clear: creating a sustainable world for future generations by preventing an increase in global warming by 2° Celsius. We all have a role to play as we try to achieve this goal in the coming years; no single company, industry sector, government or community can do this alone. Each stakeholder has a different responsibility when it comes to the energy transition and we should acknowledge that there are limitations to what each organisation - including banks - can contribute.

Banks' role in the energy transition

Banks have and will continue to play a crucial role in financing the economy. They also help providing solutions for social issues and can help build a sustainable society where clients can achieve sustainable growth. For banks operating globally, sustainable strategies will have to reflect the interests of all stakeholders; national policy makers, central banks, the industry, regulators as well as the public. Each economy has their own starting point, their own energy mix and their own unique incentives and ability to transition to a net zero world. Most banks support a wide range of companies and industries, including those in areas which are reliant on oil, gas and even coal for the most basic needs of heat, food and shelter. This will not change overnight. The key for these sectors is to become more energy efficient and banks can encourage these efforts by adjusting their individual ESG policies and procedures. However, they must do so in a responsible manner to ensure the energy transition runs a smooth course without unnecessary disruption to the financial system and the real economy.

> *Any taxonomy with the aim to define sustainability of all economic activities should have the aim of becoming a global solution to avoid fragmentation along jurisdictional lines.*

Regulatory framework and the transition

Climate change is a global issue and several important global initiatives have been developed to further monitor, facilitate and regulate the contribution from the financial services industry. The EU taxonomy is an important first attempt to draw a clear line between which economic activity is sustainable and which is not, and it creates incentives for investors to move towards more sustainable solutions. The transitional path is slowly becoming more clear due to improved reporting, enhanced risk management and more coherent public policy frameworks. And while climate change is a global phenomenon, the energy transition also has a dynamic nature given the various geographical, social economic and technological dimensions that need to be taken into consideration. Any taxonomy with the aim to define sustainability of all economic activities should have the aim of becoming a global solution to avoid fragmentation along jurisdictional lines and at the same time able to evolve dynamically, taking into consideration technical innovation in energy efficiency, energy consumption patterns and market dynamics in new energy sectors.

Working together to support the transition

Achieving net zero targets, even with the resources, talent and technology available today, is going to be a tremendous challenge. Societies at large need to work together to explore opportunities for new energy solutions. All GSIB banks are focused on understanding and managing the risks arising from climate change, including active engagement with clients. It is important that governments are transparent about what is achievable for each sector in the economy and this path forms the basis of a responsible road to decarbonised banking, allowing for a balanced road to Paris.

Gerhard Endemann

Head Sustainability, Head Environment, Wirtschaftsvereinigung Stahl (German Steel Association)

Challenges to introduce sustainable finance and taxonomy into the steel sector

EU Steel companies produce according to legal requirements, and often go beyond. Existing processes have been optimized why an increase in efficiency and reduction in environmental and climate-relevant effects is hardly possible within existing processes and plants.

Correspondingly, all companies search for new and modified processes in order to gradually enable the path to a CO_2-free and sustainable future.

The steel sector fundamentally supports the approach of sustainable financing and the goal of the change to a sustainable and CO_2-free society. But, an appropriate and solid design of sustainable finance rules is inevitable. A holistic approach is essential that takes full account of the specifics of a basic industry, its significance for the value-added networks and its enabling properties for sustainable activities.

The transformation within sectors will not happen overnight. New technologies must be developed and implemented. In the meantime, existing plants that have not yet reached the end of their life will continue to be operated. In order to rule out negative (environmental) effects during continued operation, these existing plants must be kept in optimal condition and be adapted to the best available technologies and processes must be further developed.

Transformation requires parallel financing of new technologies and further development of existing technologies.

As a result, there is a need for financing both – 1. the further development of existing systems and processes and 2. the desired transformation itself. The financing must be ensured in parallel. These are transitional activities in accordance with Article 6, Paragraph 1a of the “Regulation of the European Parliament and of the Council on the introduction of a framework to facilitate sustainable investments”.

While the taxonomy for future low-carbon technologies is defined by the “Taxonomy for Sustainable Financing” in both EU legislation and ISO standardization procedures, the conditions for the transition activities and a transformation taxonomy are still widely unclear.

Several points must be considered in a transformation taxonomy. Transformation must be accompanied by simultaneously securing the financing of both new technologies and the further development of existing technologies.

This presumes that (i) currently a low-carbon alternative is technically and economically not available, and (ii) financing in existing assets neither hinders the development of new low-carbon alternatives, nor (iii) retains carbon-intensive assets beyond the transformation period.

Therefore, companies will demonstrably create and follow a CO_2 reduction plan while aiming for continuous improvement across all existing and future processes. The industrial emissions directive is applied, and facilities are adapted to best available technology.

In principle, the same basic conditions with regard to climate protection/adaptation, emissions, water protection, nature conservation and CE shall be used for the transitional activities as for climate-neutral activities, but – except of being among the best 25% of the sector in Europe – no stronger thresholds should be set.

Due to above mentioned big challenges, setbacks in continuous improvement for technical reasons as well as setbacks because of legal or political changes must not be borne by the affected sectors.

Gerry Cross

Director of Financial Regulation, Policy and Risk, Central Bank of Ireland

The Taxonomy – the cornerstone of the Action Plan on Financing Sustainable Growth

When considering the impact of the Taxonomy and how its role could be expanded, we should firstly acknowledge, from a financial regulation point of view, the highly ambitious work set out in the European Commission's *Action Plan on Financing Sustainable Growth* and the influence it hopes to have on the financial services industry, investors and of course, regulators. It is obvious that this is an area of financial regulation that is developing rapidly. It is important for regulators and financial market participants to be well sighted on the changes. Not only on the relevant details - though these are of course very important - but also on the underlying direction of travel. What we are seeing is a material evolution in financial regulation. One which is consistent with a change in how a well-functioning economy is perceived and understood, with sustainability one of its determining features. The development of a Taxonomy of sustainable economic activities it is an essential step in supporting the flow of capital into sustainable activities in need of financing and plays a critical role in progressing towards that well-functioning sustainable economy.

Secondly, it should be acknowledged that the role the Taxonomy will play in other areas of financial regulation, most notably disclosure, will be crucial in protecting investors. Under the Regulation on sustainability-related disclosures in the financial services sector (the Disclosures Regulation) where a financial product promotes environmental or social characteristics or has sustainable investment as its objective, the financial market participant will be required to disclose information as to how those characteristics are met. The Taxonomy now extends this obligation by requiring financial products which invest in an economic activity that contributes to an environmental objective to use the criteria set out in the Taxonomy to include detailed information on that environmental objective, and describe how the investments underlying the financial product invest in activities captured by the Taxonomy.

> *A taxonomy of sustainable economic activities it is an essential step in supporting the flow of capital into sustainable activities.*

For this to work, data about company or issuer performance against the Taxonomy activity criteria will be required. So, it is timely that the European Commission is currently consulting on enhanced ESG corporate disclosure under the Non Financial Reporting Directive to target an estimated 6,000 large listed companies with a view to enhancing their delivery of high quality environmental-related reporting.

While we are still in the early stages, we can broadly see the development of a sustainable finance eco-system with the Taxonomy as the common feature. Lastly, we know the European Commission has mandated work in relation to Ecolabels for financial products and Green Bonds. The Taxonomy will, of course, play a crucial role in the development of these labels, and, it would seem fair to suggest, will continue to underpin future sustainable finance regulation.