EU SUSTAINABLE FINANCE TAXONOMY

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The EUs sustainable finance agenda, a first step of many

The pace of technological change continues to rise and as a result the impact of technology on people's lives is getting greater. The pandemic has clearly brought technology further to the forefront of our minds and is accelerating changes in consumer behaviour.

As new operators and business models emerge, it is essential to consider all of the new and different players in the financial ecosystem from the end user's perspective. For instance, as a broader range of firms from a diverse range of sectors seek to offer retail and potentially wholesale financial products, there is a need to ensure that consumers are provided with the same level of protections, and that all those participants who offer the same service, undertake the same activity, or expose consumers to the same risk are subject to equivalent regulatory requirements on a proportionate basis. Without this, consumers will face an inconsistent experience, with the potential customer detriment counteracting the benefits of greater competition and creating potential risks for market integrity and potentially also financial stability.

Despite the rapid technological changes and the emergence of new digital players, large and small, regulation has developed to respond to the traditional 20th century business model, which regulates based upon product, manufacturer and issuing or distributing entity. This creates a narrow regulatory perimeter applicable to these industries. However, a 21st century "platform company" does not need to create the underlying financial product or service to become a leading digital aggregator and distributor of those products and services. This can – in the case of financial services - create a substantial financial marketplace to complement a non-financial services marketplace. In other words, in the connected economy, a position of strength in one market, led by data, can readily be used to access another very different product market.

Looking forward, as the number and type of business able to access consumer spend data increases due to Open Banking and PSD2 this is likely to have further transformational effects on the composition of the new financial ecosystem and therefore critical components of financial markets infrastructure. The increase in competition for consumers is to be welcome, but there is a need to address how we collectively provide for the protection of consumers and clients and also to ensure a fair playing field for all market participants. Looking at the ecosystem from a consumer perspective, it will be increasingly difficult for consumers to understand the risk profiles of products attached to different entities and the associated protection they may or may not enjoy without further assistance from regulators. Understandably, a consumer sees products that are interchangeable for their needs, rather than considering in detail their regulatory regimes. There is a significant risk that an industry defined approach to regulation will fail to recognize emerging risks posed by the market changes noted above, and result in customer detriment.

In addition, a key barrier to innovation for firms is the lack of regulatory clarity regarding how 'new' and 'emerging' technologies, such as distributed ledger technology (DLT) and artificial intelligence (AI) may apply to financial sector use-cases. The current regulatory frameworks across the globe were not written with these technologies and the wider ecosystem in mind, and therefore they may not be fit for purpose. Whilst the principle of technology neutrality is important it is also essential that regulations consider the technologies where relevant. In addition, with global regulatory and supervisory direction constantly evolving, one of the main barriers results from some of the inconsistencies from one jurisdiction to another and resulting fragmentation.

Quite apart from this, there is a lack of consistent regulation of underlying products, with some at a more advanced stage unified regulation at the European level (e.g. the UCITS directive, which creates a harmonised framework for investment funds that can be sold to retail investors throughout the EU using a passporting mechanism), and other, substantial areas such as mortgages remain mostly regulated at the national level. Similarly, investments and trading have been tackled effectively at the European level, with the creation of ESMA; but while such "asset-side" regulation has been advancing, the "liability-side" (borrowing and lending) has yet to achieve the same level of harmonisation. This creates a further gap in safeguarding customers' interests at the European level and in completing the single market.

These issues are recognised by the regulatory community. Steps such as the European Commission's Digital Finance Strategy, which aims to amend the regulatory framework to make it fit for the digital era and achieve a level playing field across entity types, will be crucial in helping solve these challenges. Further, given the cross-border nature of innovation, collaboration by policymakers in different jurisdictions is essential. Regarding underlying product areas, the European Commission recognises the continuing fragmentation of credit markets, and while the Mortgage Credit Directive was a good first step towards an EU-wide mortgage credit market with a high level of consumer protection, it needs to act as a foundation and not an end-point. This is all the more important in an age of digital delivery of financial services.

CARLOS
SAN BASILIO

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EU Taxonomy: the programming language of the European green deal

«The EU Taxonomy as the catalyst for the green economic rebound»

We are still in the fighting phase of the COVID-19 crisis, but fortunately, the end is in sight, thanks to the progress in the roll-out of COVID-19 vaccines across the EU and the selfless sacrifices made by the frontline corona-warriors and by all the companies and workers who have borne such a disproportionate share of the burden.

As we are starting to see the light at the end of the tunnel, it is becoming ever more evident that the economic recovery will be green, or it won´t be at all. This conclusion derives not only from the fact that the European and national public support schemes will be financing to a large extent environmentally and socially sustainable economic activities. Indeed, a fair transition to a green economy is not a mere policy choice nor an experiment designed in a laboratory. We just need to look at the crisis wrought by the coronavirus as an early warner of what could potentially happen should a climate disaster strike. The Covid-19 pandemic will eventually subside, but the climate crisis is here to stay.

The green recovery will not happen just by accident. And showing goodwill when it comes to promoting a transition to a green and sustainable economy won´t be enough either. We need to find the right incentives in order to direct investments to green activities and start thinking more from a long-term perspective. Such a paradigm shift in economics requires not only significant investment from both the EU and the national public sector, but also from the private sector. Even more importantly, it must be based on a new programming language, that maps the way things are and that encourages people to effect change in the world. As we all know, language is action, and the EU Taxonomy will become the new programming language of the green economy that is yet to come.

> **We need to find the right incentives in order to direct investments to green activities and start thinking more from a long-term perspective.**

From this perspective, it is clear that Taxonomy is not only about organizing and classifying. Which industries should qualify for support? Should investments go exclusively to self-evidently green sectors or also to firms in carbon-intensive sectors trying to clean up? How can stakeholders be brought together to formulate a vision for the future and how can such a vision be implemented? In the public arena, where stakeholders often have very different incentives, this can be particularly challenging. We need therefore to also consider that the key concern for many companies, regions and cities is the 'fairness' portion of the 'fair and green' transition.

As we create this new language, we must work with all stakeholders to ensure a just transition where nobody is left behind and that the EU Taxonomy is workable and dynamic, responding to changes in technology, scientific evidence, new activities and data. The upcoming Delegated Act establishing the screening criteria for economic activities contributing substantially to climate change mitigation or adaptation, is a very important step in this process. Furthermore, a common EU database of Taxonomy reports would ease transparency and comparability, while avoiding duplication of data collection efforts.

In this regard, I think it is fair to acknowledge that the Commission is trying its best to come up with innovative solutions in order to create a single market for data by connecting existing databases through digital means. And, why not, maybe it is also the right time to take advantage of the latest technology, such as Distributed Ledger Technologies, to provide a single point of access to information relevant to investors and companies. Eventually, progress in this area will naturally spill over to the workstreams on taxonomy of "brown" and "social" activities, which would enhance comparability and reliability of ESG data.

Technical discussions on the EU taxonomy and political discussions on the broadness of the transition category that recognizes companies' efforts to invest in becoming carbon neutral, are not only inevitable, but a fundamental aspect of democratic law-making. As long as we have a clear sense of direction and the necessary political goodwill, it is entirely possible for this project to succeed.

JEAN-PAUL SERVAIS

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The sustainability taxonomy: an additional tool against greenwashing

The Regulation on the establishment of a framework to facilitate sustainable investment (the "Taxonomy Regulation") is an important part of the EU sustainable finance plan drawn up by the European Commission. The Taxonomy Regulation, together with the Regulation on sustainability-related disclosures in the financial services sector, is not only an important enabler for scaling up sustainable investment but also a powerful tool to protect investors from greenwashing. Indeed, by stating what economic activities are sustainable from an environmental perspective and requiring manufacturers to disclose in their pre-contractual documentation the share of the portfolio invested in such activities, the Taxonomy Regulation offers an easily readable and comparable indicator of a product's level of greenness.

> The EU cannot achieve the green transition alone, and hence global cooperation is key.

However, it still faces many challenges to ensure its effective implementation. In order to provide accurate information on the products, the information about the sustainability of activities should be easily accessible for all financial market participants, and tools should exist to measure the environmental performance of activities carried out by companies. It will also be essential to take account of proportionality in the implementation, especially in the current economic situation.

The EU cannot achieve the green transition alone, and hence global cooperation is key. Taxonomies, if developed in isolation, might lead to greater fragmentation of practices and could inhibit the growth of global sustainable finance markets. It is therefore important to limit undue fragmentation, e.g. via the International Platform on Sustainable Finance.

For national authorities, the entry in force of disclosure requirements based on the Taxonomy Regulation will entail the evaluation of environmental information published by regulated entities. Moreover, market participants and financial advisers will have to take into account the sustainability preferences of their consumers, and regulators will then have to ascertain that the proposed products adequately reflect investors' ESG concerns. In this respect, it will be of crucial importance for financial market participants to have access to standardised ESG information from investee companies.

It is therefore to be welcomed that the EU is working on a review of the NFRD, in order to enhance the delivery of high-quality sustainability related reporting by corporates. This will facilitate the gathering of information by financial market participants when developing, managing and marketing their products.

In the face of the need for a global response to climate change, the ultimate goal should be to foster coherence and consistency between the EU and global sustainability reporting. In this respect, it is encouraging that the EU is open to working with global initiatives such as the initiative of the IFRS Foundation, which aims, in close cooperation with IOSCO, to develop new global standards for sustainability disclosures by companies.

MARCEL HAAG

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Sustainable finance: a finance agenda for the transition

Sustainable finance is key to mobilising the massive investments needed to meet the objectives of the Paris Agreement and the UN 2030 Agenda on sustainable development goals (SDGs). In the EU, in particular, sustainable finance is vital to reach our targets under the European Green Deal, our strategic growth agenda for a climate-neutral Europe by 2050.The pandemic has not altered this necessity: the recovery needs to support the Green Deal and to catalyse the green transition.

To mobilise private investors,regulators need to set the targets,provide clarity on the direction of travel, and put in place credible and usable tools and frameworks.The EU Taxonomy will play a key role.It provides investors with a robust and evidence-based tool to identify opportunities for green investments in line with our 2050 environmental target.The Taxonomy Regulation adopted in June provides for a general framework that will be further refined through the adoption of delegated acts specifying the technical criteria for an economic activity to be included in the EU Taxonomy. It will be expanded and updated as technology and research evolve.

The first delegated act, defining activities that substantially contribute to the objectives of climate change mitigation and adaptation, will be adopted in April 2021 and enter into force at the beginning of 2022. A second delegated act defining activities that make a substantial contribution to the other four environmental objectives, namely protection of water resources, biodiversity and ecosystems, circular economy and prevention of pollution, will be elaborated once the Platform submits its technical input in autumn.

Furthermore, a separate delegated act will specify the taxonomy-related disclosures by which companies falling under the scope of the Non-Financial Reporting Directive (NFRD) will have to disclose their key performance indicators, i.e. share of turnover and capital expenditure, in respect of sustainable economic activities. This delegated act is planned to be adopted in Q2 2021 building on the technical advice submitted by the European Supervisory Authorities (ESAs) on 1 March.

The legislative proposal of the revision of the NFRD, to be adopted by the Commission in April 2021, is critical to the success of the sustainable finance agenda.

Sustainable finance is key to mobilise the massive investments needed to meet the objectives of the Paris Agreement and the European Green Deal.

By improving the environmental, social and governance (ESG) information that companies report, it will enable investors and assets managers to better understand the sustainability related risks to the entity (outside-in), and will enable civil society organisations to hold companies accountable for their social and environmental impacts (inside-out).

The Commission is assessing the EFRAG's recently issued recommendations on sustainability reporting standards.Currently,standards represent the best solution to address the lack of relevance and comparability of the non-financial information,as well as to ensure consistency with other pieces of sustainable finance legislation,such as the Sustainable Finance Disclosure Regulation and the EU Taxonomy.However,we recognise the importance of applying proportionate sustainability reporting requirements to SMEs:we are considering a simplified non-financial reporting standard for smaller companies to be applied probably on a voluntary basis.

HIDEAKI TAKASE

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Taxonomies and the road to decarbonization

The financial sector is making an unprecedented shift to support the transition to a low carbon economy. Environmental and social considerations have been part of financial decision-making for some time now but as a result of geopolitical, societal and market developments, this shift has accelerated at a rapid speed.

Net zero commitments from stakeholders across the public and private sector are becoming more concrete, painting a clearer picture of the shape and speed with which the energy transition will take place.

In October 2020, the new Prime Minister of Japan Mr Suga declared that by 2050, Japan will aim to reduce greenhouse gas emissions to net-zero and to realise a carbon-neutral society. This declaration is a defining moment for Japan's future energy and climate policies, and the government is developing additional policies to achieve this target. Japan wants to cut greenhouse gas emissions by 26% between 2013 and 2030. Other major economies are working towards similar ambitious targets.

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These global emissions reduction commitments require a balancing act between energy security, economic efficiency, environmental protection and safety. We need a whole economy transition in which each stakeholder is playing an important part.

In order to understand what the overall transition pathway will look like, we need to rely on consistent and comprehensive data and policy frameworks. Not only will these measure success, they will help financial institutions and central banks assess the risks related to the pathway, while at the same time seize opportunities to enhance and potentially even accelerate the transition.

Taxonomies are essential tools to help put in place a framework for ensuring we all speak the same language about the economic activities which are playing a role in the path to net zero. They assist in driving the economic shift necessary to reach the ambitious goals we set ourselves. We know from various studies that this will require significant investment in renewables, but equally important is the necessity of a significant transition from high-emitting sectors to more sustainable and energy efficient solutions. To reduce financial risk arising, the process of reducing GHG emissions over time needs to be managed in a steady and reliable manner.

Many banks are in the process of developing their own taxonomies with the purpose of supporting clients and facilitating the conversation about transition paths. Multiple taxonomy frameworks complicate for banks active in multi jurisdictions. The market perception of the current EU Taxonomy is that it could give an increased focus on transition and avoid cliff-edges. In this perspective, we welcome the EU's views that taxonomies need to be dynamic and not a static framework, as well as take into consideration transition.

Financial transactions and decision-making, in particular for large banks, are global in nature. Whilst we appreciate the challenges a single, uniform global taxonomy would bring given regional transition paths, we encourage regional policy makers to bring their expertise on taxonomies together, with the aim to design common, globally consistent principles.

ADRIANA PIERELLI
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Implementing the taxonomy – challenges and opportunities

"Reforming our financial system in such a way that it not only creates wealth, but that it creates wealth, worth having: that is the challenge we now face" – Bianca Jagger (European Commission Open Hearing on Sustainable Finance, 17 July 2017)

Since Bianca Jagger spoke those words, almost four years have passed.

This is not a complaint. In the intervening four years much serious and substantive work has been done. This remark is rather a reflection of the major challenges inherent in the sustainable finance agenda, and in the creation of a taxonomy of environmentally sustainable economic activities.

A first major challenge is the compatibility with the price system. Prices serve as strong signals guiding investment and economic activity. The data derived from the taxonomy will also serve as a strong signal identifying investments that are sustainable and that will maintain their value in the long term.

It is critical that these two mechanisms complement, and do not counteract, each other. There is in other words a need for public authorities to have a coherent approach across different areas of public policy (including energy, emissions, and transport policy).

It is critical that these two mechanisms complement, and do not counteract, each other.

A second major challenge relates to the design of the taxonomy. A short and simple taxonomy will contain limited information and will give clear and strong signals only for a limited area of economic activity.

A broader and more complex taxonomy will contain more information, covering broader areas of economic activity, but at the cost of clarity and simplicity.

The world is a complex place and managing the transition to a more sustainable economic system is highly complex, with often a need for difficult judgments as to the best transition path.

By its nature – as a piece of European legislation, and as it can be based only on judgments that have a high degree of certainty and of consensus – the taxonomy will be authoritative, foundational, but limited.

In order to meet the challenge identified by Bianca Jagger, we shall need to go beyond the taxonomy.

We shall need other, more diverse, types of data, as well as complementary frameworks that can cater for different and uncertain judgments as to what are the best transitional paths. And we shall need a financial system that uses and creates different types of data, and that facilitates those different paths.

This creates requirements and opportunities.

Key requirements include better access by investors to more, and more reliable, granular source data on companies and securities, as well as more efficient, and more effective, capital markets that can channel savings into diverse forms of innovative investment. We need, in short, progress on the revision to the Non-Financial Reporting Directive, the European Single Access Point, and all other items set out in the Capital Markets Union Action Plan.

Opportunities lie in digital innovation that can help make sense of, and derive insight from, disparate data from diverse sources and allow tracing of proceeds from ESG issuance. They lie in the enormous pent-up demand for green and sustainable investment products. And they lie in public sector actions such as the Next Generation EU issuance which can help create the foundation for liquid and efficient European capital markets.

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Unlocking the European taxonomy potential

The European taxonomy is a granular set of criteria that needs to be met in order to qualify an economic activity as sustainable. It is essentially a tool that will have multiple usages. The most important one will certainly be the requirement for non-financial companies, under the scope of the NFRD, to disclose their share of revenue, capex and opex that is aligned with the taxonomy, starting from January 2022 and based on 2021 information for the two climate related objectives. Financial companies will have similar requirements.

The taxonomy can play a pivotal role in the European environmental transition provided it is properly and swiftly implemented. It can indeed fill two important gaps that are currently preventing a quicker transition of the European economy towards a sustainable economy.

First the extent and the timeline of the industrial transformation that is required at an individual company level is usually still unknown. While the taxonomy does not directly address this issue, which is a matter of regulation of the real economy, its does address it indirectly by requiring to disclose the alignment with a granular sustainable target, creating the market incentive to converge to this target.

Second, the absence of ESG standardized, reliable and comparable data that can be shared with all users, hinders the ability to measure performance, analyze risk in a consistent way and take informed decisions on the direction of travel. The Non-Financial Reporting Standard will address this; however, the taxonomy disclosure requirements can be considered, de facto, as a first building block of an ESG reporting standard. It will be mandatory, granular, directly linked to underlying industrial activities and its implementation will require significant investments that need to be leveraged.

There are however three important issues to be addressed in order to achieve a proper implementation of the taxonomy. First, public authorities should plan a progressive implementation, the disclosure of a single alignment number can create an illusion of certainty, while most companies will only be able to produce estimates in 2022.

Supervisory bodies and companies need to recognize the underlying uncertainty and be transparent about it, to avoid expectation gaps and what could become a taxonomy washing. Second the taxonomy is currently one sided, it shows what is sustainable today but doesn't say much about the remaining dimensions of the transition: the targets, when these targets will be reached and the other dimensions of sustainability such as the social impact. It must be put in context. The completion of the taxonomy on the remaining dimensions would also help in building a meaningful picture. Lastly, the SME shouldn't not be excluded, they are part of the journey and should be supported on embarking on this journey.

The taxonomy is not a perfect tool, but it is a tool that we can build on. Both public and private sectors should create the conditions of a swift, controlled and large adoption of the taxonomy. It can be the catalyst of the necessary and urgent transformation of our economies and its operational implementation will also secure the consistency between ESG European policy choices and the reporting standards that will prevail.

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Climate Change is a generational opportunity for Europe

The Covid health crisis of 2020 created a synchronised economic depression. Europe's response was the creation of a €750bn European Recovery Fund. However, rather than just deploy the capital, Member States chose to focus on a Green Recovery, with a significant proportion of the funds to address the existential threat of climate change and the protection of the environment. In practice, this means EU spending is being guided by the newly developed Sustainable Taxonomy. The EU Recovery Plan is interlocked with the Commissions' 2019-24 priorities that included the realisation that "Europe needs a new growth strategy that will transform the Union into a modern, resource efficient and competitive economy". However, the real prize isn't intra-European, it's global.

European environmental legislation is not new. For years, Europe has been a first mover in safety standards and best practices that have become global standards. However, the European Green Deal marks a more dynamic approach and the Taxonomy has the potential to become the means by which the market will administer the carrot or the stick to companies. Winners will be those seen to solve the environmental crisis and the losers will be those thought to be the cause.

Failure to nurture companies in transition could cause them to wither before sending up new shoots.

Combined these elements create the foundations for success. European companies that exhibit strong alignment with the Taxonomy will see their cost of capital fall compared with those that don't.

The goal of climate neutrality requires significant investment and innovation. However, the proposed technical screening criteria under the Taxonomy fails to reward transition. This risks excluding our existing stock of European companies from being part of the solution. Failure to nurture companies in transition could cause them to wither before sending up new shoots and lead to Europe dependent on imports to achieve its goal. If policy rewards companies through the transition phase we will grant our existing enterprises access to cheaper capital as they change and hence fund more innovation and create the products, services and refreshed jobs to achieve EU prosperity and its climate goals.

This idea of creating a pathway isn't new. Europe has 2030 climate goals as well as the goal of climate neutrality by 2050, which recognises the need for transition plans such as hybrid autos ahead of full electric, coal to gas electricity generation and blue hydrogen ahead of green being viable. We must further embrace this approach and reward companies for becoming less bad, not just those that are good. By focusing on transition, we will incentivise European companies to allocate their existing cashflow towards green innovation as opposed to being forced into ever larger dividend yields.

Europe has grand ambitions and a once in a generational opportunity to steal a march on other continents. Most of the tools in place to achieve success, however failure to promote our existing companies in the transition phase could endanger our goals, including those beyond climate change. With small adjustments to the current agenda Europe has the potential to achieve Net Zero and in doing so become the Silicon Valley of Green Tech including the vibrancy, jobs and innovation that comes with it.