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An EU taxonomy to define green investments is expected to enter into force in 2021, but some experts want it to be used immediately to inform stimulus packages aimed at dealing with the social and economic fallout from the Covid-19 pandemic

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This article comes from the spring 2020 edition of the FORESIGHT Climate & Energy magazine, which was largely written before, or at the beginning of, the Covid-19 pandemic.

Under the new taxonomy rules, investments will have to contribute to at least one of six objectives to be able to qualify as environmentally sustainable

GREEN RULES Financial products sold as sustainable in Europe will, from 2021, have to show how they meet environmental objectives, beginning with how they contribute to climate action and the clean energy transition

BENEFITS More and better data will encourage the flow of capital to companies providing environmental solutions, make it easier for investors to identify green products and reduce greenwashing claims

KEY QUOTE The taxonomy will significantly accelerate the shift from brown to green as shareholders increasingly call for an end to high carbon infrastructure. For utilities it will no longer be enough to invest half of their capital expenditure in renewables and half in gas, they will need to invest all of it in renewables

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After 18 months of discussions, EU governments agreed in December 2019 to a common classification system to define environmentally friendly investments. The aim is to generate data that will provide clarity for investors on what is green and help guide companies on their long-term profitability in a world focused on climate action and radical emissions reduction.

"While we have a long history of developing products linked to ESG [environmental, social and corporate governance] and carbon emissions, the focus has often been on conduct rather than on what products companies are selling," says David Harris at financial index provider FTSE Russell. "One of the big problems has been the inability for investors to really understand whether companies are green or not since many do not break out their environmental services," he adds. "They may report lighting, but not what percentage of their bulbs are LEDs or construction companies may not spell out what they earn from flood defences versus other construction projects."

The taxonomy will encourage the flow of capital to companies providing environmental solutions by making it easier for investors to identify green products and reduce greenwashing claims, believes Lars Konggaard, a sustainability and business strategy advisor based in Copenhagen, Denmark. He welcomes the "enhanced degree of standardised and mandatory clarity and transparency" the taxonomy will bring.

Under the new rules, investments will have to contribute to at least one of six objectives to be able to qualify as environmentally sustainable. The initial focus will be on climate change adaptation and mitigation, with the sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and the protection of biodiversity and ecosystems following as objectives in the coming years. Investments will also have to show they do not significantly harm other environmental objectives and comply with technical screening criteria and minimum social and governance safeguards. Climate change criteria will be established by the European Commission by the end of 2020 for application by the end of 2021.

Users of the taxonomy will include the EU, or member states, when adopting measures for environmentally sustainable financial products or corporate bonds. Financial market participants will have to use it to identify green products and large companies with over 500 employees will have to disclose the proportion of their activities by revenue and the capital expenditure (capex) or operating expenditue (opex) that is taxonomy eligible.

ENGAGE SHAREHOLDERS

The need for companies to report their capex is particularly interesting for Sebastien Godinot from the Europe office of NGO WWF. "Green revenues are background looking indicators," says Godinot. "Capex determines the future of the economy. It is important for investors to know the pathway [of a company] and whether it is compatible, or not, with the Paris Agreement." The taxonomy is a "game changer" says Godinot. "It will make it much easier for investors and all stakeholders to compare peer companies." It can be used to show how far behind Exxon is in moving from brown to green and Shell's misalignment with international climate goals, he adds.

The rules will likewise boost shareholder engagement in encouraging companies to better understand their climate risk and become more sustainable, he says. "Shareholders can start being much more specific in their demands to investors and push them to go beyond basic climate disclosure and ask companies to shift their business models to be aligned with Paris," he states. This action will "significantly accelerate the shift from brown to green" as shareholders increasingly call for an end to high carbon infrastructure, says Godinot. "For utilities it will no longer be enough to invest half of their capex in renewables and half in gas, they will need to invest all of it in renewables."

Godinot also welcomes the call in the regulation for the Commission to report by the end of 2021 on how to broaden the scope of the rules to include a brown taxonomy; understanding sustainable funding is only half the picture. "A brown taxonomy is a prerequisite for work on climate risk and would be another game changer," says Godinot. "Most companies, such as power utilities, are not fully green or brown."

But the taxonomy's timetable could be speeded up if experts from European Commission's Technical Expert Group on sustainable finance (TEG), which drew up the taxonomy, get their way. The 35-member panel of investors, business leaders and climate policy experts, issued a statement on April 27, 2020 calling for the rules to inform stimulus plans aimed at getting Europe's economy back on track after the Covid-19 pandemic. "Now that decisions must be made on recovery policies, we consider it essential to use the right tools for the job," they said.

Getting everyone on the same page

What the European green taxonomy is and is not

IS	IS NOT
A list of economic activities and relevant criteria	A rating of good or bad companies
Flexible to adapt to different investment styles and strategies	A mandatory list to invest in
Based on latest scientific and industry experience	Making a judgement on the financial performance of an investment – only the environmental performance
Dynamic, responding to changes in technology, science, new activities and data	Inflexible or static

TAXONOMY ACTIVITIES AND CRITERIA

Economic activities must meet screening criteria to be included in the taxonomy. The screening criteria set requirements for:

- Substantial contribution to at least one environmental objective
- Doing no significant harm to the other environmental objectives

The criteria may include quantitative or qualitative thresholds that investors should expect companies to meet in the performance of the economic activities.

Entities must also meet minimum social safeguards in the performance of the activity.

HOW INVESTORS WOULD USE THE TAXONOMY IN FIVE STEPS

1. Identify the activities conducted by the company, issuer or covered by the financial product (e.g. projects, use of proceeds) that could be eligible
2. For each activity, assess whether the company or issuer meets the relevant criteria for a substantial contribution e.g. electricity generation <100g CO_2/kWh
3. Verify that the Do No Significant Harm criteria are being met by the issuer. Investors using the taxonomy would most likely use a due-diligence like process for reviewing the performance of underlying investees
4. Conduct due diligence to avoid any violation to the social minimum safeguards stipulated in the taxonomy regulation
5. Calculate alignment of investments with the taxonomy and prepare disclosures at the investment product level

SOURCE EU technical expert group on sustainable finance

AVOID CONFRONTATION

Whenever the taxonomy comes into being, the generation of data from corporate issuers will be a key benefit, providing an "overarching framework" that will "drive more and better reporting and analysis and, ultimately, greater capital allocation into green industries," says Harris. The classification system will "inevitably help clean up the market" given the "technical screening criteria is robust and the procedure on which it is based is independent and scientific," adds Tom Jess from think tank E3G.

“This is going to make available a great deal more information on sustainability,” agrees Nicholas Pfaff from the International Capital Market Association (ICMA). “It will vastly improve the depth and granularity of information.” The new rules are, however, “not a panacea” and while a “common benchmark is useful”, it may simply underline “there is no single way forward,” says Pfaff. “Industries are complicated with highly complex supply chains. It is not clear how much the data will really tell us and how actionable it will be. The market needs to be able to take the information and effect change. It should not just become a blunt instrument that leads to sterile confrontation between companies and stakeholders.”

Generating the required data will be more difficult for smaller companies, acknowledges

Sandrine Dixson-Declève, senior associate at E3G and a member of the TEG. The whole idea was to avoid making the rules so burdensome they could stop companies bringing environmental solutions to the market, she says. “Having a body of knowledge we can build on is most important,” says Dixson-Declève. “The system will naturally evolve over time,” adds Harris.

Konggaard agrees, underlining the need for balance. “The requirements must be sufficient to ensure the end-goal and ensure the credibility of green financial products, but requirements must not be set at an unrealistic level,” he says. “Unnecessary administrative burdens must be minimised and ideally avoided.”

BROAD GLOBAL IMPACT

Both Jess and Harris raise the prospect of the taxonomy having a wider reach and being included in other policies. We need the market to start using the taxonomy and then we need policymakers to “expand its limits to other parts of the policy landscape,” says Jess. “It could be used in a multitude of ways, including [to influence] the engagement practices of shareholders with investee companies and to set investment strategies for public funds.” He also expects to see “standards and labels”, such as those under development for green bonds, and for the data generated to influence policy making on sustainable development and to be used when updating Europe’s clean economy policy framework, such as the energy efficiency directive.

The taxonomy’s influence in increasing supply and demand for sustainable financial products will not be limited to the EU, says Konggaard. “It will impact a number of like-minded economies, which offer financial products in the EU and which will also be obliged to disclose their alignment with the taxonomy.” As the first major instrument of its kind, he believes it will influence legislation in other countries and has “the potential to become a leading star for setting a global standard”.

The taxonomy is “very significant globally” and the EU will become a model of best practice, agrees Pfaff. FTSE Russell is engaging with Canada and various Asian countries on the issue. “We need to try to encourage them not to reinvent the wheel, but to use it as a starting point and build from it, adapting it for local markets,” says Harris. Work on global standards will play out in the International Platform on Sustainable Finance, set up in October 2019 by Argentina, Canada, Chile, China, India, Kenya, Morocco and the EU.

PALE GREEN PROBLEMS

Whether or not to include natural gas or nuclear energy in the taxonomy garnered widespread attention, but investors already working on sustainable products seem less interested in the issue. “Sustainable finance is not involved in any significant way in fossil fuels or nuclear,” says Pfaff firmly. “This is a big debate for the energy transition, but not for us as we are not financing nuclear and gas.” Coal and gas are excluded from being labelled “green” unless plants are fitted with carbon capture and storage technology, while a decision on whether nuclear power should be excluded or not should be taken later in 2020.

Pfaff also plays down the notion of explicit greenwashing, suggesting few borrowers deliberately pretend brown assets are green. “The problem is a lack of agreement about what is green enough. Many projects are considered too pale green, but this is not greenwashing. The taxonomy will mean that discussions can be much more informed.” Dixson-Declève agrees. “Greenwashing is a reflection of what the markets have in place,” she says. “Lots of companies think they are sustainable, but there is a distinction between what they think and what we say is green — we are talking about net zero.”

The regulation sets three types of activities that can contribute substantively to environmental objectives: environmentally sustainable activities that align with low or net zero ambitions; those that directly enable other activities to contribute to climate change adaptation and mitigation; and transition activities, where there is no technologically or economically feasible low carbon alternative, such as the steel industry. Today there is no zero carbon steel, but there are types of steel production which pollute far less than others, so those are included in this category. Ensuring such activities are only used where there is genuinely no option will also be important in avoiding greenwashing.

“Transition activities will gradually have to be removed from the taxonomy as they are replaced by fully sustainable ones,” says Godinot. “Activities that impede the transition to low carbon must not be included. There is a huge urgency to tackle climate change and we have to be careful not to impede the carbon neutral movement.”

Indeed, some commentators have criticised the taxonomy for not going far enough and not being more prescriptive about the types of clean technologies that need more investment, but Jess is clear it should be recognised for what it is. “The taxonomy is not a silver bullet, but one part of the change that needs to happen to funnel more money away from fossil fuels and towards clean energy. As such it should, and will, evolve in the coming years.”

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