Sustainable finance - taxonomy

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Political context

In the last decades, the **EU** has been able to impose itself **as a leader of the international climate negotiations**, playing a pivotal role in the adoption of the Kyoto Protocol and the Paris Agreement.

The fight against climate change was high in the agenda of the EU leaders in the last few years and **in 2018** this has become one of the top priorities at European level when the Commission adopted the EU Action plan on financing sustainable growth.

The **European Parliament** has adopted its resolution on climate and environmental emergency on 28 November 2019 with which it:

“1. Declares a climate and environment emergency; calls on the Commission, the Member States and all global actors, and declares its own commitment, to urgently take the concrete action needed in order to fight and contain this threat before it is too late;

2. **Urges the new Commission to fully assess the climate and environmental impact of all relevant legislative and budgetary proposals**, and ensure that they are all fully aligned with the objective of limiting global warming to under 1,5 °C, and that they are not contributing to biodiversity loss;

…

4. Urges the new Commission to address the inconsistencies of current Union policies on the climate and environment emergency, in particular through a **far-reaching reform of its agricultural, trade, transport, energy and infrastructure investment policies**;

Political context (2)

The European Commission announced on 11.12.2019 **the Green Deal** - a set of policies proposed by the European Commission that should make **Europe climate neutral by 2050**. The plan is to reduce the levels of greenhouse gas emissions by at least 50- 55% compared to 1990 levels.

Commission plans to **review every EU law and regulation** in order to align them with the new climate goals. This will start with the Renewable Energy Directive and the Energy Efficiency Directive, but also the Emissions Trading Directive and the Effort Sharing Regulation.

The scale of the investment challenge is beyond the capacity of the public sector alone.

Sustainable finance is a work stream to support the European Green Deal channeling **private investment** to the transition to a climate-neutral economy.

Commission is of the view that the **financial sector has a key role to play in reaching the goal of climate neutrality** and has developed a comprehensive policy agenda on sustainable finance since 2018, comprising the Action plan on financing sustainable growth and is currently working on the development of a **Renewed sustainable finance strategy**.

The objectives are to:

- **re-orient investments** towards more sustainable technologies and businesses:
- finance growth in a sustainable manner over the long-term
- contribute to the creation of a low-carbon, climate resilient and circular economy.

The Commission is also coordinating international efforts through its **International platform on sustainable finance**.

Sustainable finance - Mind shift

"By David Rubens

Kermit the Frog once famously sang ‘It’s not easy being green’.

And he was right – being truly green takes a lot more effort than perhaps many people realise. And this is true not just at a personal level, but for society as a whole.

Every day, I see people around me going to great lengths at a personal level to contribute to a greener world, to take care of the planet we live on. **I see people biking in any kind of weather, installing solar panel systems, people eating only organic food, even people making their own shampoo or washing powder.**

While I applaud these efforts, I can’t help but wonder if these people have thought about **greening their personal finances too.** Because if they haven’t, all their efforts might be in vain.

While our money is not the first thing that comes to mind when we think about environmentalism, **our finances can have a huge impact on the future of this planet**. Let me give you an example. Say that **you bike to work every day**, because you care about the amount of CO2 emissions in the atmosphere, but at the same time, **your bank invests all the money on your bank account in the oil industry**.

Wouldn’t that offset your personal efforts?

But you can do something about it**. Moving your bank account to a sustainable bank is easy – in fact, it takes less time and effort than it does to make shampoo! I tried it – it takes 10 minutes (switching banks, not making shampoo).**

As an example, the amount of money ‘sitting’ in Belgian savings accounts alone is a stunning €290 billion. Imagine if that money was used **only for green sectors (or at least was removed from brown sectors).** And that’s only bank accounts; sustainable finance is also about greener pension funds, insurances, bonds, etc.”

Sustainable finance – legislative package

In May 2018 the Commission presented a package of measures as a follow-up to its action plan on financing sustainable growth. The package included **3 proposals** aimed at:

- establishing a unified EU classification system of sustainable economic activities - '**taxonomy**'
- improving disclosure requirements on how institutional investors integrate environmental, social and governance (ESG) factors in their investment decision making and risk assessment processes – **Sustainable finance disclosure regulation**
- creating a new category of benchmarks which will help investors compare the carbon footprint of their investments – **EU Climate benchmarks regulation**.

- Commission has also established 2 working groups:
  - **TEG – Technical expert group** – to assist in the development of the taxonomy. It has 35 members from civil society, academia, business and the finance sector, as well as additional members and observers from EU and international public bodies
  - **MSEG – Member States expert group** – to assist the European Commission in implementing EU legislation and policies related to sustainable finance. Every Member state has 2 representatives - financial market expert and environmental expert.

Sustainable finance disclosure regulation - SFDR

SFDR introduced various disclosure-related requirements **for financial market participants and financial advisors** at entity, service and product level. It aims to provide more transparency on sustainability within the financial markets in a standardised way, thus preventing greenwashing and ensuring comparability.

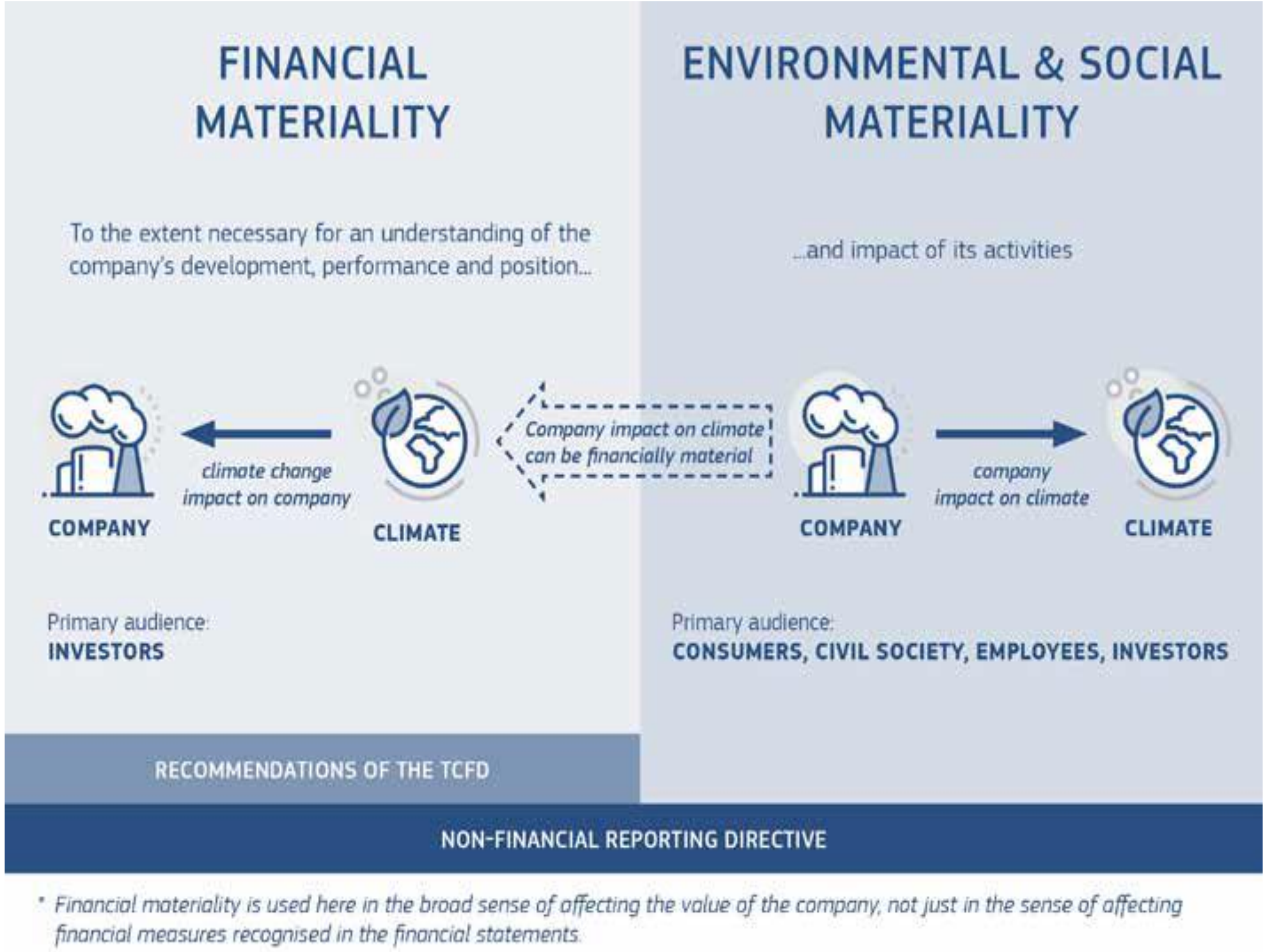
SFDR will apply directly to:

- **Financial market participants** that manages client money in some way - bank or investment firm providing portfolio management, an asset manager (i.e. AIFM or UCITS ManCo), a pension provider or an insurance undertaking which provides insurance-based investment products (IBIPs); or
- **Financial advisers** that advise on investments or investment strategy, e.g. a bank, investment firm or asset manager that provides investment advice, or an insurance undertaking or intermediary that provides advice on IBIPs.

The majority of the new disclosure obligations will be applicable as of **10 March 2021**.

The requirements are:

- **At entity level -** to integrate ESG (environmental, social and governance risks) in the investment decision making process and to introduce a due diligence process to assess the impact of the investments on the ESG factors .
- **At product level** – to disclose additional information for the products that have as objective sustainable investments in pre-contractual information, periodic reports etc.


FINANCIAL MATERIALITY
ENVIRONMENTAL & SOCIAL MATERIALITY
To the extent necessary for an understanding of the company's development, performance and position...
...and impact of its activities
COMPANY
climate change impact on company
CLIMATE
Company impact on climate can be financially material
COMPANY
company impact on climate
CLIMATE
Primary audience:
INVESTORS
Primary audience:
CONSUMERS, CIVIL SOCIETY, EMPLOYEES, INVESTORS
RECOMMENDATIONS OF THE TCFD
NON-FINANCIAL REPORTING DIRECTIVE
* Financial materiality is used here in the broad sense of affecting the value of the company, not just in the sense of affecting financial measures recognised in the financial statements.

EU Climate benchmarks

With this regulation labels for EU Climate benchmarks have been created.

- An **'EU Climate Transition Benchmark**' means a benchmark where the underlying assets are selected, weighted or excluded in such a manner that the resulting benchmark portfolio is on a decarbonisation trajectory and is also constructed in accordance with the minimum standards laid down in the delegated acts.
- An **'EU Paris-aligned Benchmark**' means a 'benchmark where the underlying assets are selected in such a manner that the resulting benchmark portfolio's GHG emissions are aligned with the long-term global warming target of the Paris Climate Agreement and is also constructed in accordance with the minimum standards laid down in the delegated acts.
- The new legislation also lays down a number of ESG disclosure requirements for benchmark administrators, including the disclosure on the alignment with the Paris agreement.

Taxonomy regulation

What is the aim of the Taxonomy Regulation?

The Taxonomy Regulation sets out an EU-wide framework - a classification system which is called “taxonomy” that defines which economic activities are “**sustainable**”.

The taxonomy is being developed currently only in relation to the environmental aspects. The social and governance will be developed at a later stage. Now there are some elements introduced.

The ultimate aim is to encourage investment flows from the financial sector to companies engaged in more sustainable activities or that enable transition to more sustainable economy so that the EU can become carbon neutral by 2050 and meet its climate change goals.

The EU taxonomy is designed to have a common understanding what is **“green”** and to prevent greenwashing.

Taxonomy regulation – what is a sustainable economic activity

Criteria for environmentally sustainable economic activities:

- contributes substantially to one or more of the 6 environmental objectives
- does not significantly harm any of the environmental objectives
- is carried out in compliance with the minimum social safeguards (as OECD Guidelines on Multinational Enterprises and the UN Guiding Principles on Business and Human Rights)
- complies with technical screening criteria that will be established in delegated acts.

Taxonomy objectives

- climate change mitigation;
- climate change adaptation;
- the sustainable use and protection of water and marine resources;
- the transition to a circular economy;
- pollution prevention and control;
- the protection and restoration of biodiversity and ecosystems.

Who does the Taxonomy Regulation apply to?

The Regulation is designed for use by:

- Member states and EU institutions when setting **rules about financial products and corporate bonds that are made available as environmentally sustainable** – for example the taxonomy will be used to define green bond standards. Commission is expected to propose a EU green bond standard in 2021.
- Financial market participants who offer financial products and market these as environmentally sustainable
- Financial and non-financial undertakings that are covered by the Non-Financial Reporting Directive are required to disclose information on how, and to what extent, their products and businesses are aligned with the taxonomy - so that investors can make more informed decisions.

Transparency of undertakings in non-financial statements

1. Any undertaking which is subject to an obligation to publish non-financial information pursuant to Article 19a or Article 29a of Directive 2013/34/EU shall include in its non-financial statement or consolidated non-financial statement information on how and to what extent the undertaking's activities are associated with economic activities that qualify as environmentally sustainable under Articles 3 and 9 of this Regulation.

2. In particular, non-financial undertakings shall disclose the following:

- (a) the **proportion of their turnover derived from products or services associated with economic activities that qualify as environmentally sustainable** under Articles 3 and 9; and

- (b) the **proportion of their capital expenditure and the proportion of their operating expenditure** related to assets or processes associated with economic activities that qualify as environmentally sustainable under Articles 3 and 9.

Entry into force

TEG has proposed technical screening criteria for the first 2 objectives (climate mitigation and climate adaptation) in its final report from 9 March 2020.

Commission has drafted a delegated act on the basis of the TEG report which is published for consultation with a deadline - **18 December**.

The criteria for the first 2 objectives will be applicable from **1 January 2022**.

The criteria for the other 4 objectives will be applicable from **1 January 2023**.

The Platform on sustainable finance will take over the work of TEG and start work in 2021 on the technical screening criteria for the other 4 objectives.

The Platform will work also to advise the Commission on the possible extension of Taxonomy to significantly harmful and low impact activities as well as to social objectives.

Taxonomy - link with other initiatives

Taxonomy use in the public sector – Commission is currently exploring the possible use of the definition of “environmentally sustainable investment” in Union law, and at Member State level.

In its communication related to the Green deal and the investment plan Commission has stated that it will work with the Member States to screen and benchmark **green budgeting practices**.

This will make it easier to assess to what extent annual budgets and medium-term fiscal plans take environmental considerations and risks into account, and learn from best practices.

There will be a debate for any possible future steps including how to treat sustainable investments within EU fiscal rules.

The Commission will propose minimum mandatory **green criteria or targets for public procurements in sectorial initiatives, EU funding or product-specific legislation**.

Such minimum criteria will ‘de facto’ set a common definition of what a ‘green purchase’ is, allowing collection of comparable data from public buyers, and setting the basis for assessing the impact of green public procurements.

Public authorities across Europe will be encouraged to integrate green criteria and use labels in their procurements. Life-cycle-costing methodologies should be applied by public buyers whenever possible.

Non-financial reporting Directive - NFRD

Upcoming review in Q1 2021:

- In its 11 December 2019 Communication on the European Green Deal, the Commission committed to review the non-financial reporting directive in 2020 as part of the strategy to strengthen the foundations for sustainable investment.

- In line with that commitment, on 20 February 2020 the Commission launched a public consultation on the review of the NFRD.

Results on NFRD consultation

- **Problems for users of non-financial information**: The majority of respondents believe that the non-financial information reported by companies is deficient in terms of comparability (71% of respondents), reliability (60%) and relevance (57%).
- **Problems for preparers of non-financial information**: 64% of respondents who are or who represent preparers (reporting companies) stated that additional requests for non-financial information, for example from rating agencies or NGOs, are a significant problem, and 38% experience significant problems regarding the complexity of the current situation and deciding what information to report.
- **Very strong support for a requirement on companies to use a common standard**: 82% of respondents believe that a requirement on companies to use a common standard would address the identified problems.
- **Strong support for simplified standards for SMEs:** 74% of respondents support the development of simplified standards for SMEs. 46% replied that such standards should be mandatory for SMEs, and 39% replied that they should be voluntary.
- **Strong support for stricter audit requirements:** 67% of respondents believe that the EU should impose stronger audit requirements for non-financial information - limited assurance or reasonable assurance.

Results on NFRD consultation (2)

- **Strong support for digitalisation of non-financial information**: 64% of respondents say that it would be useful to require the tagging of non-financial information to make it machine readable, and 65% say that all reports containing non-financial information should be available through a single access point.
- **Strong support for a requirement on companies to disclose their materiality assessment process:** 72% of respondents believe that companies should be required to disclose their materiality assessment process. Moderate support for requiring all information to be disclosed in the management report: 55% of respondents believe that all information should be disclosed in the management report, removing the option of publishing the information in a separate report.
- **Strong support to use taxonomy structure for environmental disclosures:** 69% of respondents believe that the NFRD should define environmental disclosures according to the six environmental objectives set in the Taxonomy Regulation.
- **Strongest support to expand the scope of the NFRD to certain categories of company**.

Key note speech of Steven Maijoor for the paradoxes of sustainability reporting

Steven Maijoor, Chair of the European Securities and Markets Authority (ESMA), has delivered yesterday (8.12.2020) a keynote speech at the webinar “A new standard for a new capitalism: accelerating corporate responsibility through non-financial information” organised by the French Ministry of the Economy, Finance and Recovery.

In his speech, Mr Maijoor highlighted 3 apparent **paradoxes of sustainability reporting**:

- the need to ensure that reporting standards are, at the same time, **international and jurisdiction-specific**;
- the importance of ensuring that the disclosure standards are sufficiently robust to help prevent the risk of **greenwashing**, while at the same time allowing for sufficient flexibility for entities to tell their *own story*; and
- the difficulty of establishing a robust and extensive disclosure regime covering as many companies as possible so to ensure that information by (actual or potential) investee companies is available, while maintaining **a proportionate set of requirements especially for smaller companies**.

International context of sustainability reporting

“Almost all developed countries face the risk of having to slow down the progress towards the environmental objectives of the Paris agreement, due to the economic consequences of the pandemic. In order to mitigate this risk, as recently highlighted by the IMF , improved transparency and standardisation in sustainability taxonomies and reporting could further help mobilise green investments and support major recovery programs, such as the Next Generation EU.

The international flow of investments that will be needed to support the green transition will require the assessment of investee companies **by investors based in third-countries**. Similarly, **EU investors may well target investee companies based in third countries**. In both cases, the relevant assessments can be made much more effective and efficient by the availability of a set of generally accepted international reporting standards.“

"Intelligence is the ability to adapt to change" Stephen Hawking