EU TECHNICAL EXPERT GROUP ON SUSTAINABLE FINANCE

Statement of the EU Technical Expert Group on Sustainable Finance (TEG)

5 high-level principles for Recovery & Resilience

15 July 2020

The *EU Technical Expert Group on Sustainable Finance* (TEG)[1] was established to advise the European Commission on implementation of the Action Plan for Financing Sustainable Growth.

In the context of current negotiations about resilience and recovery measures the TEG proposes five high-level *Principles for Recovery & Resilience* supported by detailed recommendations for applying the Taxonomy to the EU's Recovery Package. Recovery planning refers to the Multiannual Financial Framework (MFF) and Next Generation EU (NGEU).

PRINCIPLES FOR SUSTAINABLE RECOVERY AND RESILIENCE

COVID-19 will not be an isolated pandemic. The crisis has its roots in pathogens transferring between species in degraded ecosystems[2]. Climate change and biodiversity loss are key drivers of environmental stress. Given the increasing pressure on our environment triggered by climate change and biodiversity loss, experts are warning that we should expect more pandemics. This pandemic is the first of what is likely to be a century of shocks related to environmental degradation.

To respond we need to:

1. Plan a recovery that focuses on Building Back Better.

Green stimulus needs to be ambitious as well as efficient. Action is needed urgently to meet the at least 50% emission reductions needed by 2030 - while also creating jobs and stimulating our economies.

The EU Taxonomy is a tool designed to help identify projects that deliver on the green transition, that help polluting activities transition, that help low carbon activities' access to finance.

Funding for the package could be generated through the issuance of green recovery bonds, issued under the proposed EU Green Bond Standard.

The recovery package offers a unique opportunity to invest in the next generation and to start building a carbon neutral, environmentally sustainable and inclusive economy.

2. Build resilience into everything, so we are better prepared for a volatile future.

All investments now need to consider issues of adaptation and physical resilience in the face of a rapidly changing climate and increasing climate impacts. This crisis teaches us that we also need to be aware of Social, Economic and Ecological resilience factors we need to address to be prepared for future climate shocks. Accordingly, preparedness for future shocks needs to be a factor in all recovery measures, while we also reduce the risk of extreme climate change with measures to reduce emissions.

To ensure the recovery enables resilience building, we need to encourage investments in:

- **Social resilience:** activities that enable social cohesion and co-operation and ensure that the most vulnerable are able to access social and health systems without putting themselves at risk. This crisis has taught us that building resilience to climate change and other shocks has to include health system resilience. Health systems need to be able to scale up quickly for future pandemics and other health crises including those created directly by climate change such as extreme heat events; and access has to be available to all.
- **Economic resilience**: Jobs need to be created in sectors that contribute the most to a more sustainable and resilient economy - sectors that need to grow in the future and are prepared for climate change impacts. Enormous opportunity exists for job creation in sectors such as energy efficiency, distributed solar, afforestation and environmental remediation.

[1] This document represents the overall view of the members of the Technical Expert Group. However, although it represents such a consensus, it may not necessarily, on all details, represent the individual views of member institutions or experts. The views reflected in this document are the views of the TEG experts and it does not reflect the views of the European Commission or its services.

[2] *The role of ecosystems in mitigation and management of Covid-19 and other zoonoses*, Mark Everard, Paul Johnston. David Santillo and Chad Staddon. https://www.ncbi.nlm.nih.gov/pmc/articles/PMC7247996/

- **Ecosystem resilience:** a focus on healthy ecosystems is needed to reduce the risk of future pandemics. That will mean protecting and rebuilding natural capital and biodiversity in Europe while mitigating climate change to minimize climatic impacts on ecosystems.

3. Ensure that recovery investments, grants and spending at least do no harm

The Taxonomy framework can inform all areas of the recovery and spending:

- The Multiannual Financial Framework and Next Generation EU must avoid harm by respecting the Do No Significant Harm and Minimum Safeguards requirements of the EU Taxonomy for all investments, not only "Green" ones.
- The quantity of spending and investments making a substantial contribution, in line with the Taxonomy criteria and framework, should be prioritised. The Taxonomy should be used in tracking climate commitments.

Part 2 of this document sets out rationale for why the Taxonomy should be used for this purpose and guidance for how this can be done.

4. Apply all these measures to both private and public sectors.

A close working relationship between the two will be necessary to recover from the crisis.

There are many opportunities for collaboration, from regulation to rigorous voluntary agreements, from promoting transparency to low carbon public procurement. Most important will be clear policy signals capable of creating stable and robust frameworks to attract private investment, including reinforcement of the EU target of reaching zero emissions by 2050.

5. Collaborate internationally to better serve resilience

Most climate shocks will be regional. Mutual supports agreements, including food and health, could be an important step to avoid the failure of states caught in a shock.

And we need to work towards having a common global language around sustainability (Taxonomy) to guide our economies – and our recovery efforts.

IMPLEMENTING THE TAXONOMY IN EU RECOVERY PLANNING

The Taxonomy framework can inform **all areas** of the recovery and spending:

1. The Multiannual Financial Framework and Next Generation EU must avoid harm by respecting the Do No Significant Harm and Minimum Safeguards requirements of the EU Taxonomy.
2. The quantity of spending and investments making a substantial contribution, in line with the Taxonomy criteria and framework, should be prioritised. The Taxonomy should be used in tracking progress on climate financing commitments through the MFF and NGEU.

What follows is our rationale for the application of the Taxonomy illustrated with examples of practical application. The TEG stands ready to support the EU and Member States in developing these concepts further.

Why use the Taxonomy for Green Recovery?

1. **The EU Taxonomy was designed to help direct finance to support a sustainable investment system.** The High-Level Expert Group on Sustainable Finance, which recommended the EU to develop such a Taxonomy, originally envisaged a wide range of uses spanning public and private actors and including (but not limited to) measuring financial flows towards sustainable development priorities at the EU and Member State level and identifying assets that qualify for financing under sustainable EU and Member State sustainable financing mechanisms.[3]
2. **The Taxonomy has been precisely tailored to identify investments that can drive delivery of the EU's environment and climate objectives**, and to identify activities at risk of causing signficant harm to progress against those objectives. The Taxonomy is based on extensive analysis of the European economy and presents screening criteria for sectors contributing over 93% of Europe's scope 1 GHG emissions. The Taxonomy does not yet cover all sectors of the economy including aviation, certain metals and rare earths, however the key concepts or principles the Taxonomy rests upon can be for defining technical screening criteria for sectors not yet covered. In addition, some of the technical screening criteria (such as those for low carbon technologies) provide an interpretive framework allowing some flexibility on the part of the issuer or project promoter. Where this more subjective or principles-based approach is used, TEG strongly recommends considering the approach taken by the proposed EU Green Bond Standard, which enables some interpretive flexibility subject to external audit or verification.
3. **The Taxonomy is robust, science-based and avoids unintended consequences**. The Taxonomy Regulation requires the Taxonomy criteria to meet strict standards including technology neutrality, scientific basis and adopts the precautionary principle. The Taxonomy framework can support the EC, Member States and other actors evaluate whether an investment in an activity makes a substantial contribution to one or more environmental objectives while avoiding significant harm to the rest. Consideration of all six environmental objectives is critical to avoid perverse impacts which can occur through narrow focus on one environmental objective without consideration of the rest. For example, supporting renewable energy but not being mindful of biodiversity or food supply needs.
4. **The Taxonomy directly responds to the EU's environmental challenges**. The Taxonomy reflects six key European environmental objectives, including climate change mitigation, adaptation and biodiversity. It has been recognised as a central component of the European Green Deal.
5. **The Taxonomy can direct finance to the transition**. The EU economy is not yet on a transition pathway aligned with net-zero. Many economic activities are being performed which cause significant harm. The Taxonomy defines an upper level (substantial contribution) and a minimum acceptable level (Do No Significant Harm) to steer and motivate investments to make substantial contributions, without penalising good investments that do not substantially contribute but are not harming other environmental objectives. The Taxonomy can be used to support a well-managed and equitable transition away from harmful activities and simultaneously maximising the positive contribution of Taxonomy-aligned activities. By applying the Taxonomy exclusions, and its Do No Significant Harm criteria and approach, for <u>all</u> investments, not only "Green" ones, the do no harm oath can be supported whilst simultaneously promoting investments in greening of activities and activities that are aligned with the transition required by the Green Deal.

[3] https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf

6. **The Taxonomy is a tool to prevent social harm.** The Taxonomy Regulation recognises the relevance of minimum safeguards - with regards to human rights, labour rights, social broader aspects, anti-bribery and anti-corruption – and establishes that “compliance with minimum safeguards must be a condition for economic activities to qualify as environmentally sustainable. The minimum safeguards in the Taxonomy were designed to ensure that Taxonomy activities do not harm social objectives – in essence, a form of Do No Significant Harm to social aspects. For that reason if the Taxonomy is applied to direct EU recovery packages, it will ensure investments respect the highest social standards in all investments.

7. **The Taxonomy can enable better cooperation between the EU, Member States, companies, municipalities, public finance institutions and investors.** Implementation of the recovery plans will result in unprecedented investments from national and EU budgets which must be aligned with a sustainable and equitable recovery. Achieving an economic recovery and ensuring a pivot towards a green transition will require an unprecedented level of cooperation between national and regional governments, public and private finance institutions and companies. The Taxonomy - a shared understanding of “sustainable” – is necessary to enable proper cooperation between public and private stakeholders and increase synergies between all aspects of the recovery package.

Detailed application

To demonstrate how the Taxonomy can be applied, the TEG has considered three Next Generation EU instruments in detail. However, these concepts could have wider application and the TEG remains ready to support the EU in developing these ideas further.

Taxonomy and EU GBS in Next Generation EU

Next Generation EU is proposed to be financed through European Commission borrowing of EUR 750 billion. Aligning the deployment of the recovery instruments with the Taxonomy would enable the Commission to issue **EU Green Bond Standard aligned debt**.

Within the Next Generation framework, InvestEU, including the new Strategic Investment Facility, makes a direct reference to the Taxonomy. However, there are additional possible applications of the Taxonomy in other areas, notably in the Recovery and Resilience Facility and the Solvency Support Instrument (the three instruments are highlighted in bold above and discussed in more detail in this paper). In addition, the Taxonomy could be relevant for Horizon Europe (research and innovation), Rural development (agriculture is a well-developed Taxonomy area), REACT-EU (cohesion funding), rural development funding and the Just Transition Fund (which should be considered part of the overall support in cases where economic impacts of the environmental transition are accelerated by the COVID recovery).

Pillar 1: Supporting Member States to recover	Pillar 2: Kick-starting the economy and helping private investment	Pillar 3: Learning the lessons from the crisis
▪ Recovery and resilience facility (mix of grants and loans) ▪ State Aid ▪ REACT-EU ▪ Rural development ▪ Just Transition Fund	▪ **Solvency support instrument** ▪ **InvestEU** ▪ **Strategic investment facility** (implemented as an additional policy window within InvestEU).	▪ Health programme ▪ RescEU ▪ Horizon Europe ▪ Neighbourhood, Development and International Cooperation ▪ Humanitarian Aid

The instruments highlighted in **bold** have been discussed in more detail in this paper (noting that there will be additional applications, such as Horizon Europe (research and innovation), Rural development (agriculture is a well-developed Taxonomy area) and Just Transition Fund (which can be considered part of the overall support in cases where economic impacts of the transition are accelerated by the COVID recovery).

Below, we suggest ways in which the Taxonomy can be applied across the three highlighted instruments. We note that technical support could be offered by the Commission for the design and application of the Taxonomy within these instruments, to Member States who request it.

Recovery and Resilience Facility

Summary

The Recovery and Resilience Facility (RRF) is a (EUR 560bn) mix of grants and loans. Its objectives include supporting the green and digital transition.

To access the facility, Member States are required to prepare recovery and resilience plans covering 2020-2024, with a cap for the maximum possible allocation for each country. These plans must contain a mix of reforms and public investment projects. The facility makes payment in instalments based on milestones and targets which build from the country-specific plans, the green transition agenda, National Energy and Climate and Just Transition plans. Member State plans are already under active development.

The 25% of climate mainstreaming target applies also to the RRF.

The Commission takes a role in monitoring the implementation of the facility by Member States and measuring the achievement of these objectives based on quarterly reporting by Member States, as well as in providing country-specific recommendations.

Application of the Taxonomy

The Taxonomy, and underpinning concepts, could be applied as a frame for understanding options to be included in development and implementation of recovery and resilience plan, both in terms of the reform and public investment elements.

Given that the Commission takes a role in monitoring the implementation of the facility by Member States and measuring the achievement of these objectives based on quarterly reporting, Taxonomy alignment can be reflected in the Commission's evaluation of Member State plans, reporting templates milestones/targets for facility payments, and country-specific recommendations, where possible. Below, we set out some approaches that could be taken.

When considering climate change mitigation, the Taxonomy differentiate between three types of activities: low carbon, transition and enabling. These concepts could be used in further specifying and targeting the types of reforms and investments included in the plans for climate change mitigation:

- Low carbon activities are those already operating at a level close to net-zero performance. Targeted policy reform and investment to expand and develop these sectors is necessary.
- Transition activities are those which are a substantial source of carbon emissions and where substantial investment and policy reform is required to improve environmental performance.
- Enabling activities are those which support other sectors of the economy to make a substantial contribution, on a lifecycle basis. As with low carbon activities, these sectors need to be expanded and developed.

When considering how the Taxonomy can **guide investments in sustainable activities** (the positive agenda, climate mainstreaming), the following could apply:

- Any <u>new</u> facilities, major infrastructure or installations supported by the plan (either from a policy or financial perspective) should seek to achieve "substantial contribution" Taxonomy alignment <u>at minimum</u> and seek to align to the "low carbon activities" thresholds where possible (ie. not "transition"). All companies, including those with already low carbon operations could benefit from this approach.
- Member States could establish challenge funds enabling companies, municipalities or other project developers to bid for a combination of grants, loans or investments to bring their existing activities in line with the "substantial contribution" criteria. For example, where the Taxonomy sets a carbon intensity threshold, companies should establish a plan to achieve that threshold over several years. This is strongly consistent with the TEG's recommendations that investment as part of a plan to achieve Taxonomy-alignment, with suitable controls (such as verification of results), ought to be considered a critical element of climate financing. [4] This

[4] See TEG final report page 15: *Some economic activities will already meet the technical screening criteria. For those that do not, the TEG recommends that the financing of improvement measures (capex and, if relevant, opex) can be counted as Taxonomy-aligned if they are part of an implementation plan to meet the activity threshold over a defined time period (TEG recommends a limit of five years for these plans). In the case of climate change adaptation, the plan should directly respond to the climate risks identified in the assessment required by the adaptation principles.*

approach would create enduring benefits to the companies or issuers in question as they would continue to be able to claim Taxonomy-alignment over the long-term, increasing their profile in ESG-badged funds. The criteria are technology neutral and any innovative technology could be considered aligned assuming it met the criteria, which could in turn lead to wider deployment and roll-out of innovative technologies in line with net-zero. Further alignment could be made with HorizonEurope project funding to ensure a faster pace and greater scale.

- The Taxonomy establishes cross-cutting/horizontal activities which can make a substantial contribution to climate change mitigation. Member States could establish dedicated programmes of financial and policy support for cross-cutting activities which can apply across multiple sectors, such as energy efficient retrofit of buildings (the TEG has recommended a series of energy efficiency measures which should be considered to make a substantial contribution to climate change mitigation), installation of low carbon technologies in particular in the hard to abate sectors including manufacturing, power and transport as well as fleet upgrades to zero tailpipe emission vehicles or mobility shifts to rail. This could also present an opportunity for Member State issuance of EU Green Bonds.

Measures to avoid causing harm are fundamentally targeted at transition activities and should be considered in combination with the TEG proposed approach under the Solvency Support Instrument (below). Minimum safeguards should be applied across the board irrespectively of the type of investments or finance mechanism.

Recovery and resilience plans need to work to establish plans for how sectors of the economy at risk of causing harm can transition away from harmful activities, including through the managed phase-out of extremely harmful activities (the Taxonomy recognises that certain activities including coal production and use, dedicated transportation and storage of fossil fuels can never be brought in line with the Paris Agreement and therefore can never make a substantial contribution to climate change mitigation. In this respect they are not foreseen as green economic activities). However, companies conducting such activities could benefit greatly if they use any finance aid to transform their businesses by diversifying their portfolios (e.g. oil & gas companies investing in green hydrogen or renewables).

The Recovery and Resilience Facility can maximise synergies with the Solvency Support Instrument by identifying companies in sectors at high risk of causing environmental harm (building from EU ETS). From an emissions perspective it should go beyond the current EU ETS and also address aviation, maritime transport and infrastructure and agriculture.

Where the Taxonomy has established significant harm criteria for specific economic activities, these can be the starting base. However, the Taxonomy does not contain criteria for all activities at risk of causing significant harm (such as aviation). In this case, the following options are recommended:

1. Activities could be supported where they can demonstrate they do not cause significant harm or they have a solid plan to meet the criteria within 5 years according to the legal definitions of “Significant Harm” embedded in the Taxonomy Regulation, further supplemented by the Article 10 principles, specifically the activity:
    a. has greenhouse gas emission levels that correspond to the best performance in the sector or industry or a solid plan to reach best performance within 5 years (for example, short-haul flights should not be supported where a journey by rail is viable);
    b. does not hamper the development and deployment of low-carbon alternatives; and
    c. does not lead to a lock-in of carbon-intensive assets, considering the economic lifetime of those assets;
    d. incorporates the climate adaptation requirements to reduce all material physical climate risks to the extent possible and on a best effort basis and ensure that adaptation measures do not adversely affect the adaptation efforts of other people, nature, and assets.
2. Quantitative CO2 caps/benchmarks could be established, for example linked to sector average performance or better (this is reflected in some TEG recommendations, notably for energy generation the TEG recommends the “Do No Significant Harm” to mitigation is aligned to EU average energy generation emissions intensity);
3. Best Available Technologies minimum requirements must be followed.

Solvency Support Instrument

Summary

The Solvency Support Instrument is directed to companies who are negatively affected by the pandemic and unable to access market financing for business continuity. The financing and investment operations should be aligned with the EU Green Deal and target companies with high potential for green or digital transformation. Companies should be encouraged to comply with minimum high-level social and environmental safeguards in line with guidance provided by the Steering Board. Companies with exposure to a pre-defined list of harmful activities, in particular the sectors covered by EU ETS, should be encouraged to put green transition plans in place in the future.

Application of the EU Taxonomy

1. **Use of the Taxonomy to identify companies with high potential for green transition.**

The Taxonomy differentiates between three types of climate change mitigation activities: low carbon, transition and enabling. Each could be considered relevant for identification of companies with high potential for the green transition in particular.

- Low carbon activities are those already operating at a level close to net-zero performance. Targeted investment to expand and develop these sectors is necessary.
- Transition activities are those which are a substantial source of carbon emissions and where substantial investment is required to improve environmental performance.
- Enabling activities are those which support other sectors of the economy to make a substantial contribution.

2. **Use of the Taxonomy to demonstrate compliance with high-level social and environmental safeguards.**

All Companies receiving support should commit to undertake environmental and social due diligence in line with the minimum safeguards approach laid out in the Taxonomy, which builds in particular from the OECD Guidelines on Multinational Enterprises.

Where the Taxonomy sets objective criteria for the avoidance of significant harm, companies can then demonstrate how these are met or are planned to be met alongside their due diligence (noting that this will be most challenging for high carbon emission companies, who are also required to establish a green transition plan – see below).

Due diligence considers an important principle of proportionality, meaning that SMEs should be able to comply in a way that is consistent with their resources.

3. Green transition plans

The Taxonomy, in combination with the governance and strategy principles of the Taskforce on Climate-Related Financial Disclosure expressed in the TEG's disclosure recommendations, could form the basis of green transition plans. It is important to differentiate between improving the environmental performance of existing assets/facilities and ensuring that all future assets/facilities are making the maximum effort to be aligned with the low-carbon transition.

Such a transition plan will need to, at a minimum, ensure that:

Appropriate governance around sustainability risk is established by. aligning with Paris Agreement goals, or carbon neutrality by 2050 at the latest, in line with the EU Taxonomy in Europe, integral to their corporate strategy. This should be supported by board level responsibility and alignment of governance arrangements with appropriate reporting.

1. All future capex (and if relevant, opex) is directed towards Taxonomy-alignment a, demonstrating a substantial contribution to either climate change mitigation or adaptation <u>and</u> avoiding significant harm to other environmental objectives.
2. All existing activities should be screened for potential to cause significant harm with reference to the Taxonomy screening criteria (and minimum safeguards) and plans put in place to move from causing significant harm to becoming neutral or low impact activities. Where activities do not have the potential to transition (such as coal production and use,

dedicated transportation and storage of fossil fuels) plans for phase-out/winding down of the activity should be established.

It is critical here to consider the other elements of the recovery package. For example, the **Resilience and Recovery Facility** could contain targeted, direct grants or loans to companies seeking to implement their transition plans and the **Just Transition Mechanism** could directly support regions affected by the phase-out of significantly harmful activities. In addition, investors will be seeking investment opportunities aligned with the EU Taxonomy and EU GBS and this may increase the availability of private finance to support company transition.

Transition plans are required for companies in high-priority sectors, mainly those in EU ETS. However, some harmful sectors (such as aviation, shipping) are not covered by EU ETS, the Taxonomy or both so an alternative approach would be required. This could look like:

1. Activities could be supported where they can demonstrate they do not cause significant harm according to the definitions of "Significant Harm" embedded in the Taxonomy Regulation, further supplemented by the Article 10 principles, specifically the activity:
    a. has greenhouse gas emission levels that correspond to the best performance in the sector or industry (for example, short-haul flights would not be supported where a journey by rail is viable);
    b. does not hamper the development and deployment of low-carbon alternatives; and
    c. does not lead to a lock-in of carbon-intensive assets, considering the economic lifetime of those assets.
2. Quantitative CO2 caps/benchmarks could be established, for example linked to sector average performance or better;
3. Best Available Technologies minimum requirements should be followed.

Finally, companies benefiting from recovery support should be required to develop Climate Risk and Vulnerability Assessments covering all material climate risks - in their supply chain and business locations and staffing etc - so that they can start to build themselves into a more resilient business future.

InvestEU / Strategic Investment Facility

Summary

The Commission has brought forward a revised InvestEU proposal which establishes the Strategic Investment Facility as a 5th policy window, in addition to sustainable infrastructure (substantially increased in size under the revised proposal), research, innovation and digitisation, SMEs and social investment and skills.

The Commission is responsible for developing climate and environment tracking and sustainability proofing guidance using the criteria established in the Taxonomy regulation. InvestEU also has mandatory exclusions.

Recommended next steps

<u>The TEG recommends the Commission, European Parliament and Member States apply the key principles of the Taxonomy to the stimulus package, noting the importance of the "Do No Significant Harm" principle - no finance should support activities which are harmful to environmental objectives and the social requirements defined in the Taxonomy.</u>

<u>Specifically, all funding vehicles could use the terminology established within the Taxonomy for: i) Low carbon activities ii) Transition activities and iii) Enabling activities as described above.</u>

<u>For activities where thresholds are defined within the Taxonomy the thresholds should be applied.</u>

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