TOWARDS A WORKABLE EU TAXONOMY

POLICY PAPER

ABOUT

Aristote is the brand name of a recently created advisory activity I launched to help corporates and financial institutions to deal with all regulations related to the so called "Sustainable Finance" EU strategy, especially in the fields of risk management, disclosures and taxonomy.

In this area, one of the main challenges for companies is to be able to improve the communication of information on non-financial risks and opportunities, by linking them clearly with their strategy. This implies adopting new developments, innovations and good practices in terms of information data and communication, both at European and international level.

In parallel to this advisory activity, I teach the economics of climate change in the "International Affairs & Development" Master's Degree of Dauphine-PSL University, where I teach Finance since 1992. The course aims to explain global warming, biodiversity, the disappearance and depletion of resources, consequent public policies, and the impacts this should have on corporate and financial institutions business models in a microeconomics perspective.

Based on this background, I believe to be in a position to provide a legitimate and experienced-based contribution to the Commission's work on the "Renewed Sustainable Finance" project.[1]

Laurent Lascols
July 10, 2020

[1] After an exchange with the Joint Transparency Register Secretariat (JTRS), as Aristote (i) doesn't represent any clients on behalf of whom it is interacting with the EU institutions, and (ii) has no eligible "own activities", it is not subject to a registration in the EU Transparency Register.

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EXECUTIVE SUMMARY

The first words of the Technical Expert Group (TEG) final report[2] released in March 2020 defines the EU Taxonomy as *"a tool to help investors, companies, issuers and project promoters navigate the transition to a low-carbon, resilient and resource-efficient economy"*.

Does the framework under implementation really keep this promise?

The first objective of European Commission action plan released in March 2018[3] was *"to reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth"*.

According to Collins Dictionary, to reorient means *"to adjust or align (something) in a new or different way"*. But actions 1 to 5 dedicated to this objective in the action plan, only focused at the sustainable side of this question. And the action 1, related to the establishment of an EU classification system for sustainable activities, has the same bias.

Without being caricatural, the approach could be compared to a public policy which would aim at building a sustainable agriculture by focusing only on the definition of what could be a perfect permaculture.

Yet, the role of transitioning and enabling activities will be key to reach the environmental and sustainability goals, both at the EU and global level. Focusing only on already "best in class" companies and excluding companies based on existing activities is likely to be very insufficient to reach sustainability goals and could ultimately exclude some sectors that are dependent on excluded activities.

And reorient capital flows towards sustainable investments means also to shift it away from unsustainable financing, e.g those which don't comply with Paris targets agreement and more generally with the Sustainable Development Goals (SDGs). This implies to define some sort of "brown" taxonomy, keeping in mind that many shades of brown will coexist for a while in our economies.

In practice, the Commission should determine a more granular approach (several thresholds), which will determine a transition pathway for each sector and hence allow the economy and the markets to reward compagnies that engage on this pathway. The purpose is clearly not to implement punitive legislations, but help all stakeholders to work together to contribute to the transition.

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[2] https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/200309-sustainable-finance-teg-final-report-taxonomy_en.pdf

[3] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52018DC0097

Due to the complexity and highly technical nature of developing such a classification system, it will take time to arrive at a fully-fledged EU sustainability taxonomy, covering climate, environment and social aspects.

And it will be essential, first in the drafting of the two delegated acts, second in the steering of the *"Platform on Sustainable Finance*", to keep in mind that the tools must be workable.

This workability is a condition to be in a position to use this tool in the various labels under construction, whether we speak of sustainable bonds, loans or other financial products.

It is also a key condition to reach an international consensus on the subject.

On various aspects of sustainable finance, the capacity for the EU to take the leadership is relatively clear. This is the case on the question of internalization of carbon pricing[4] or on the non-financial disclosure's legislation[5].

This is probably less clear at this stage on the taxonomy chapter and prioritizing and mobilizing the International Platform on Sustainable Finance to its full potential will only be possible if the EU Taxonomy framework is convincing and, again, workable.

[4] Cf. our position paper dated July 8, 2020 "The price of carbon, the only real question"

[5] Cf. our position paper date June 8, 2020, attached to our answer to NFRD revision consultation

INTRODUCTION

This paper is produced to be joint – together with an opinion on carbon pricing - to our answer to the consultation on *Renewed Sustainable Finance*[6], first stage of the renewed strategy announced with the Green Deal, the complete framework to be proposed by European Commission being expected in autumn 2020.

In its introduction to the consultation paper, the European Commission makes a reference to the ongoing COVID-19 outbreak which *"underscores some of the subtle links and risks associated with human activity and biodiversity loss". "It is important – now more than ever – to address the multiple and often interacting threats to ecosystems and wildlife to buffer against the risk of future pandemics, as well as preserve and enhance their role as carbon sinks and in climate adaptation."*

I believe this is the first time the link between climate change and biodiversity exhaustion is highlighted as clearly in an official communication ….

The European Green Deal Investment Plan – also called *Sustainable Europe Investment Plan* – announced on 14 January 2020 its intention to mobilise public investment and help to unlock private funds through the EU budget and associated instruments, notably through the InvestEU programme.

Since then, in the new context created by COVID-19 outbreak, the Commission unveiled a recovery package containing a reinforced long-term EU budget for 2021-2027, as well as the new Recovery Instrument, 'Next Generation EU'.

When adding Next Generation EU to the proposed size of the 2021-2027 MFF of €1.1 trillion, the total financial firepower of the EU budget reaches €1.85 trillion, equivalent to around 13% of EU GDP at 2019 levels.

The response to the pandemic is an opportunity to step up efforts to achieve the environmental objectives of the European Union (EU) by incorporating sustainability considerations when steering the financial response to the crisis.

The *Renewed Sustainable Finance Strategy* announced with the European Green Deal was supposed predominantly focus on three areas: (i) strengthening the foundations for sustainable investment by creating an enabling framework, with appropriate tools and structures ; (ii) increasing opportunities to have a positive impact on sustainability for citizens, financial institutions and corporates; (iii) fully managing and integrating climate and environmental risks into financial institutions and the financial system as a whole, while ensuring social risks are duly taken into account where relevant.

[6] https://ec.europa.eu/info/consultations/finance-2020-sustainable-finance-strategy_en

The necessary transition to a low GHG economy is going to require rapid and far-reaching transitions in energy, land, urban, infrastructure and industrial systems. The costs and pathway for the transition will change over time depending on future choices made (infrastructure investment, decision by policy makers, shift of consumers towards greener choices …). Nevertheless, the estimated costs of this transition will be small compared to the costs of no climate action.

The link between sustainability and finance is essential, and finance has an undeniable role in this transition as it is the provider of means for the necessary shift to materialize. Financial flows must clearly reorient towards sustainable projects, and it has been made mandatory with the Paris Agreement in 2015 through its article 2.c, which states the objective of *"making finance flows consistent with a pathway towards low greenhouse gas emissions and climate resilient development".*

But this shift doesn't materialize fast enough. And it would be very naïve to believe that the development of so called "green" finance is going to be sufficient. The question of "unsustainable" financing activities must be addressed too.

In this paper, we focus on climate issues, but let's be honest, it's extremely difficult to draw a frontier line between climate and other environmental issues, and beyond, social and governance matters. In reality, the different crises we have to deal with are closely linked with each other.

After reminding the founding principles that guided the drafting of EU Taxonomy legislation, this paper advocates for a clarification of the way transitional and enabling activities will be dealt with. It suggests expanding the methodology towards Social and Governance criteria on one side, and towards so called "brown" activities (with all shades of brown in between) on the other.

Finally, it warns against the risk of defining unpracticable Technical Screening Criteria, making difficult to use this taxonomy tool in the various labels under construction, whether we speak of sustainable bonds, loans or other financial products. It is also a key condition to reach an international consensus on the subject.

I. THE EU TAXONOMY

The first sentence of the Technical Expert Group (TEG) final report[7] released in March 2020 defines the EU Taxonomy as *"a tool to help investors, companies, issuers and project promoters navigate the transition to a low-carbon, resilient and resource-efficient economy"*.

Does the framework under implementation really keep this promise?

1. Founding principles

The Taxonomy is based legally on a political agreement[8] reached on December 17, 2019. The level 1 text was definitely adopted by the European Parliament on June 18, 2020.

It sets performance thresholds (referred to as *'technical screening criteria'*) for economic activities which:

- make a substantive contribution to one of six environmental objectives: climate change mitigation, climate change adaptation, sustainable use and protection of water and marine resources, circular economy, pollution prevention and control, protection and restoration of biodiversity and ecosystems;
- do no significant harm (DNSH) to the other five, where relevant;
- meet minimum safeguards (e.g., OECD Guidelines on Multinational Enterprises and the UN Guiding Principles on Business and Human Rights and the eight fundamental conventions identified in the International Labour Organisation's declaration on Fundamental Rights and Principles at Work and the International Bill of Human Rights).

Source : Final report of the Technical Expert Group on Sustainable Finance

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[7] https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/200309-sustainable-finance-teg-final-report-taxonomy_en.pdf

[8] https://data.consilium.europa.eu/doc/document/ST-14970-2019-ADD-1/en/pdf

For the *technical screening criteria*, the text requires (article 14) to take into account the nature and the scale of the economic activity to possibly include *"enabling"* and *"transitional"* activities, and to take into account the potential market impact (risk of certain assets becoming *"stranded"* or risk of bubbles on "*sustainable"* investments).

2. The users of the Taxonomy

Once it is fully developed, EU Taxonomy will have to be used by:

- Member States and the European Union when they say that public measures, standards or labels concerning financial products or corporate bonds offered by financial market participants or issuers are "environmentally sustainable".
- Financial market participants when they offer financial products will be required to disclose information on how and to what extent the investments that underly their products meet the criteria for environmental sustainability under the Taxonomy Regulation. For those products that do not invest in taxonomy-compliant activities, a statement will need to be made by the financial market participant, saying that the relevant investments do not take into account the EU Taxonomy Regulation. Transition finance that does not meet the screening criteria may still reduce harm to environmental objectives, but would not, in reference to the Taxonomy criteria, be considered sustainable.
- Financial and non-financial companies when they fall under the scope of the Non-Financial Reporting Directive (NFRD); they will have to disclose information on how and to what extent the undertaking's activities are associated with environmentally sustainable economic activities with reference to the Taxonomy. By 1 June, 2021, the European Commission will adopt a delegated act specifying how the corporate disclosure obligations should be applied in practice. The delegated act will consider the differences between non-financial and financial companies.

II. "NAVIGATE THE TRANSITION"

1. Too narrow an approach

Climate-related and environmental risks are not stand-alone: the "gilets jaunes" movement in France started with a legislation on carbon taxation, and more recently, the COVID-19 pandemic showed how environmental challenges are closely linked to the way social and governance aspects are dealt with.

But the framework under implementation is also seriously insufficient as it doesn't provide stakeholders with a mean to assess the activities which are in transition or don't comply with environmental sustainability criteria, leaving space to a large spectrum of undefinable activities.

Without being caricatural, the approach could be compared to a policy which would aim at building a sustainable agriculture by focusing on the definition of what could be a perfect permaculture.

Climate-related and environmental risks are not binary. Ultimately, companies, banks, financial institutions and their supervisors have to ensure the proper management of risks of the entire spectrum of asset classes and their "green", "brown" or "different shades of brown" exposures.

To make a long story short:

- the "green" is defined, but not the "brown", with its many different shades, present in all economic activities;
- beyond climate and environment, important sustainability issues are left aside (Social and Governance).

What has been done so far could be summarized as follows (in green):

Criteria	"Green »	Transition and "different shades of brown"	"Brown »
Climate adaptation and mitigation	Taxonomy regulation + first set of technical screening criteria (delegated acts)	No	No
Sustainable use and protection of water and marine resources, circular economy, pollution prevention and control, protection and restoration of biodiversity and ecosystems ;	Taxonomy regulation + second set of technical screening criteria (delegated acts)	No	No
Social	No	No	No
Governance	No	No	No

The approach of the Commission, to focus first on redirecting capital flows towards environmentally sustainable activities was understandable: developing criteria for environmentally sustainable economic activities across the six environmental objectives defined in the Taxonomy Regulation, was already a very large task.

And by providing a framework to assess whether the environmental performance and minimum social standards of new investments are aligned with the social, climate and environmental goals of the Union, the Taxonomy could prove a precious tool for directing the unprecedented spending programmes that are being put in place at EU and national levels towards sustainable uses.

2. <u>From “green” to “brown”</u>

The challenge is indeed not only to make finance greener but to bring about a greener economy.

Beyond straightforward “green” activities, the Taxonomy also accommodates certain transition-friendly activities which currently lack a technologically and economically feasible low-carbon alternative as well as so-called “enabling activities”. But these notions remain very vague, and it’s very difficult to understand how this type of activities will be dealt with.

Yet, the role of transitioning and enabling activities will be key to reach ambitious environmental and sustainability goals, both at the EU and global level. Focusing only on already “best in class” companies and excluding companies based on existing activities is likely to be very insufficient to reach sustainability goals and could ultimately exclude some sectors that are dependent on excluded activities.

It’s for the very same reason that it would make sense to develop further a “brown” taxonomy (covering those activities that do significantly harm environmental sustainability), to give a better understanding of the activities that are not in line with environmental objectives and the EU-wide trajectory for greenhouse gas emission reductions.

In practice, the Commission should determine a more granular approach (several thresholds), which will determine a transition pathway for each sector and hence allow the economy and the markets to reward compagnies that engage on this pathway. The purpose is clearly not to implement punitive legislations but help all stakeholders to work together to contribute to the transition.

Based on this expanded taxonomy, banks and investors should be in position to provide financing resources to support companies in their transition process, exclusion strategies being used only for the “brownest” activities.

Companies that perform activities not yet covered by the Taxonomy could complement their Taxonomy-alignment disclosure with an explanation that the results reflect the fact that their activities are not yet covered, as opposed to them being unable to meet technical screening criteria. TEG believes this is an important signal for companies to be able to send.

This classification system could also be used on a voluntary basis by any other market actors, other than those captured by the Non-Financial Reporting

Directive (SMEs for example). Above all, this system should help companies to raise finance for sustainable activities, by encouraging them to publish the percentage of their turnover or investments that is in line with the "green list" of environmentally sustainable activities.

In this perspective, the fact to have expanded the scope to transitional and enabling activities would help to capture some companies willing to make progress.

III. THE TECHNICAL SCREENING CRITERIA

1. Process of elaboration

Based on the level 1 regulation, the European Commission will develop two delegated acts that will supplement the principles set out in the regulation and determine in a precise manner if an economic activity may qualify for an environmental objective:

- The first set of technical screening criteria, for activities which substantially contribute to climate change mitigation or adaptation, will be adopted by the end of 2020 and enter into application by the end of 2021.
- The second set of technical screening criteria, which cover economic activities substantially contributing to the other four environmental objectives, will be adopted by end 2021 and enter into application by end 2022.

In March 2020, the Technical Expert Group (TEG) released its final report[9], supplemented by a Technical Annex[10] of 593 pages containing:

- A full list of revised or additional technical screening criteria for economic activities which can substantially contribute to climate change mitigation or adaptation (the two first environmental objectives), including assessment of significant harm to the four other environmental objectives).
- Methodological statements to support the above recommendations.

Actually, the TEG's mandate was only to consider the four environmental objectives (pollution prevention and control, use and protection of water and marine resources, circular economy, and protection and restoration of biodiversity and ecosystems) in the context of avoiding significant harm.

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[9] https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/200309-sustainable-finance-teg-final-report-taxonomy_en.pdf

[10] https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/200309-sustainable-finance-teg-final-report-taxonomy-annexes_en.pdf

A full evaluation of economic activities that can substantially contribute to one or more of these four objectives will be completed by the *"Platform on Sustainable Finance"*, an advisory body composed of stakeholders representing civil society, public bodies and academia, that will assist the Commission in this task and provide advice on other sustainability objectives.

In parallel, a *"Member State Expert Group"* will contribute in an advisory capacity.

2. Towards a workable framework

The founding principles reminded hereabove are intellectually very convincing.

But the definition of Technical Screening Criteria could prove to be burdensome at best, unpracticable at worse.

The Technical Annex joint to the TEG final report of May 2020 - almost entirely focused on Technical Screening Criteria issue - makes 593 pages … to deal with the two first environmental criteria only.

In this context, it will be essential, first in the drafting of the two delegated acts, second in the steering of the *"Platform on Sustainable Finance*", to keep in mind that the tools must be practicable.

At the end of the day, the objective is to have a sustainable economy, not a compartment of finance dedicated to pure niche players.

IV. BEYOND EU TAXONOMY

1. Norms and labels

Unless there are well justified reasons for differentiating the definition of the sustainable or green investment across different financial products, there should not be differences in principle in the definition applicable across financing instruments.

Provided that the Taxonomy framework remains simple and practicable, the definition of the sustainability (and unsustainability) of the economic activities underlying the labels for different financial product would in principle be the same.

Based on these principles, the green bond standard would be built on transparent criteria publicly available to investors and assessed by independent third parties. The accreditation/ authorization and supervision regime at the EU level could naturally come from the European Securities and Markets Authority (ESMA).

The key attributes of the EU green bond standard should be integrated in the Prospectus

Green loan standards and definitions should also be based on same criteria.

Any initiative on so called “green securitisation” should also be closely linked to the Taxonomy.

By allowing banks to transfer risks off their balance sheets, green securitisation would allow the financial sector to lend more to green projects and activities, as risks are better shared across a wider range of investors. It would be particularly useful to aggregate Energy Efficiency or SME equipment loans for example.

Green securitisation should comply as much as possible with the existing STS framework, with only limited deviations where appropriate, for example on concentration limits (as, in the early days, a potentially limited supply of green loans should not be a barrier to the development of green securitisation).

The EU should ensure maximum consistency across the various pieces of regulation applicable to green securitisation and take advantage of the strong framework already developed for securitisation. Again, the “workability” of Technical Screening Criteria is essential here.

2. International cooperation

This question of workability is also essential in the perspective of international cooperation.

To enhance international cooperation, ehe EU should leverage all available tools and fora (G7, G20, International Organization of Securities Commissions (IOSCO), International Accounting Standards Board (IASB), Basel Committee on Banking Supervision, Network for Greening the Financial System (NGFS), International Organization for Standardization (ISO), the Coalition of Finance Ministers for Climate Action, etc.).

On various aspects of sustainable finance, the capacity for the EU to take the leadership is relatively clear, but on taxonomy, prioritizing and mobilizing the International Platform on Sustainable Finance to its full potential will only be possible if the practical declination of the Taxonomy framework is convincing and, again, workable.