BRIEFING

EU Legislation in Progress

European Parliament

Sustainable finance – EU taxonomy

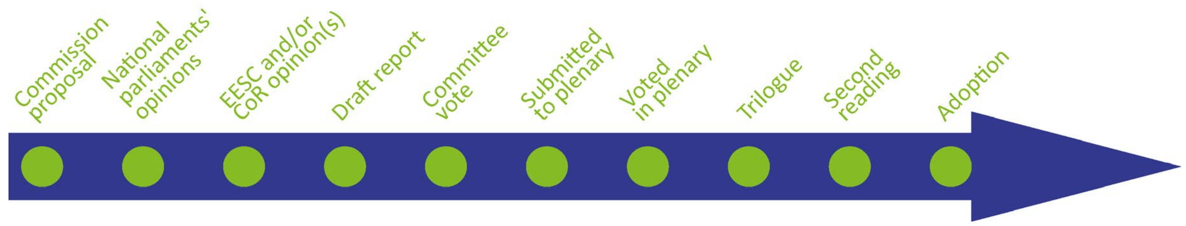
A framework to facilitate sustainable investment

OVERVIEW

In March 2018, the European Commission presented an action plan on sustainable finance, in order to facilitate investments in sustainable projects and assets across the EU. In May 2018, the Commission put forward a package of three proposals, including measures to create a sustainable taxonomy for the EU; provide clarity on how environmental, social and governance factors can be taken into account for investment decisions; and establish low-carbon benchmarks.

The first proposal focuses on establishing a common language for sustainable finance (e.g. a unified EU classification system, or taxonomy) through a framework of uniform criteria, as a way to determine whether a given economic activity is environmentally sustainable. On 11 March 2019, the ECON-ENVI joint committee adopted a report on the Commission proposal, calling for a number of changes. On 28 March 2019, the Parliament adopted its position at first reading. After interinstitutional negotiations, on 17 June 2020, the Parliament adopted the compromise text at second reading. The final act was published in the Official Journal on 22 June, and applies as of 12 July although certain provisions apply only as of January 2022 or January 2023.

Proposal for a regulation of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment		
Committees responsible:	Economic and Monetary Affairs (ECON) and Environment, Public Health and Food Safety (ENVI) (jointly under Rule 55)	COM(2018) 353 24.5.2018 2018/0178(COD)
Co-rapporteurs:	Sirpa Pietikäinen (EPP, Finland) and Bas Eickhout (Greens/EFA, the Netherlands)	Ordinary legislative procedure (COD) (Parliament and Council on equal footing – formerly 'co-decision')
Procedure completed.	Regulation 2020/852 OJ L 198, 22.06.2020, pp. 13–43.	



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Introduction

Sustainable finance generally refers to the process of taking due account of environmental, social and governance considerations in investment decision-making.

Taxonomy -- from the Greek *taxis*, meaning arrangement or division, and *nomos*, meaning law -- is the science of classification according to a predetermined system, with the resulting catalogue used to provide a conceptual framework for discussion, analysis or information retrieval.

According to the European Commission, given their commitments to environmental and climate policy goals at both international (e.g. Paris Agreement) and EU level, more and more Member States are likely to explore the option of introducing labels for sustainable financial products, using their own bespoke taxonomies. There is currently no clear, standard international framework that defines what is 'sustainable' and what is 'green', even though a number of market initiatives have emerged.

The existing lack of clarity as to what constitutes an environmentally sustainable economic activity could be exacerbated if Member States attempt to take action in that field individually, without coordination. This would place national barriers within capital markets operating for the purpose of raising funds for sustainable projects. Diversifying classification systems would increase market fragmentation and raise competition problems, making it more difficult and costly for investors to understand what is and what is not sustainable.

To address existing divergences and prevent any further barriers to the internal market from emerging, this proposal aims to establish a standard EU-level definition of what qualifies as an environmentally sustainable economic activity for investment purposes, by introducing a clear, unified EU taxonomy and the related concept of environmentally sustainable investment.

Such standardisation is expected to provide appropriate signals to economic players as to what activities are considered sustainable; protect private investors by avoiding risks of greenwashing;[1] and provide the basis for further meaningful action in areas such as labels, disclosures and prudential rules.

The expected EU added value of the proposal lies in its potential to enable the mobilisation of sustainable finance across the EU, while ensuring a high level of financial stability. A unified taxonomy and the monitoring of sustainability of investments will support the uptake of sustainable finance in the European financial sector.

Greater clarity on what can be considered an environmentally sustainable investment will facilitate access to cross-border capital markets for such investments. In fact, providing standard criteria will make it easier for investors to identify the relative environmental sustainability of a given investment and to compare investments both nationally and across Member States.

A taxonomy developed through EU legislation will have significant impact on the financing of sustainable activities: just as energy-labelling guides consumer choices towards energy-efficient products, such a taxonomy would aim to guide investor choices towards investments in environmentally sustainable activities.

After the implementation of a unified EU taxonomy, the next step – according to the action plan on sustainable finance – will be to use this taxonomy to guide the integration of sustainability into the management of financial institutions such as banks, insurance companies and pension funds.

Sustainability benchmarks are a good example of how taxonomy can shape policy and investment decisions. There is currently no standard or agreed definition as to what constitutes a sustainable fund or index.

In the future, the Commission would evaluate whether it is appropriate to extend the scope of the proposed regulation to cover other sustainability objectives (in particular social ones) and the common notion of environmentally sustainable investment used in EU and Member State legislation.

Context

Achieving EU sustainability goals requires major investments. In the climate and energy areas alone, it is estimated that additional annual investment of €180 billion is needed to meet climate and energy targets by 2030.[2] A substantial part of these financial flows will have to come from the private sector. Closing this investment gap means reorienting private capital flows towards more sustainable investment, and rethinking the European financial regulatory framework in a comprehensive way. This is the main aim of the action plan on financing sustainable growth, presented by the Commission in March 2018.

Building on the action plan and addressing its first priority, the present proposal is designed to standardise the way in which an investment's degree of environmental sustainability is determined, by laying down the criteria that such an investment must fulfil. It aims to ensure that financial market participants who offer financial products as environmentally sustainable investments, or as investments with similar characteristics, would make it clear to investors why such products can be considered environmentally sustainable, building on uniform criteria established at EU level.

In his speech at a high-level conference on financing sustainable growth, European Commission Vice-President, Valdis Dombrovskis, explained that other elements of the action plan are dependent on the launch of a taxonomy system, that is, a common language for sustainable finance. Furthermore, Commissioner Dombrovskis more recently observed: 'One issue, which is probably not politically controversial, but is quite complicated technically, is setting up the EU taxonomy system'. He then added, 'We see it as a complex start, but when we have it in place, then other actions can branch off the taxonomy. Then you can apply labels, you can apply the green supporting factor and you can provide clarity in terms of fiduciary duty'.[3]

The Commission, the European Parliament and stakeholders consider taxonomy an important factor in achieving sustainable finance. Moreover, there is consensus on the need to review the taxonomy regularly, in order to align it with market developments.

In terms of consistency with other regulations, the proposal uses concepts already available in the context of existing environmental policies. It builds on the concepts developed under the 7th Environmental Action Programme, the Water Framework Directive, the action plan for the circular economy, and the Industrial Emissions Directive.

The common understanding of what constitutes environmentally sustainable investment will complement existing EU environmental policies, by providing a reference point for them in the future, and by ensuring that new policies are developed and implemented in a more consistent manner. Moreover, the same consistency will be ensured for other policies involving EU investment. It has already been anticipated that the forthcoming Invest EU programme (for 2021 to 2027) will adopt the EU sustainability taxonomy.

Existing situation

Currently, Member States differ in their interpretations of sustainable investment. Some have labelling schemes or market-led initiatives in place to determine what qualifies as 'green' for investment purposes, while others do not have any rule in place but are likely to legislate in this field, based on their own definition of sustainable investment.

National labels based on different criteria, determining which economic activities qualify as environmentally sustainable, make it difficult for investors to compare green investments, thus discouraging them from investing across borders. Existing divergences are also a burden on economic operators, who need to comply with different standards in different Member States.

At the same time, the need to finance sustainable development is increasing. The transition to a sustainable economy requires large amounts of investment that can only be realised through the financial sector – the only sector capable of collecting sufficient funds and distributing them through loans or emissions of bonds.

The aim to better address the above need requires a comprehensive framework that would help define not only the concept of sustainable finance but also its working processes and governance, and would guarantee its continual evolution in line with the evolution of the sustainability concept.

At the moment, such a comprehensive framework does not exist. Instead, there are different frameworks adopted by a number of individual Member States or produced by some market-led initiatives; this situation creates market fragmentation, confusion for investors and room for greenwashing practices.

Comparative elements

A number of Member States have already put their own sustainable finance initiatives into place. Examples include France's law of disclosure,[4] Germany's commitments on making substantial public investment in the energy transition, and the Swedish Financial Supervisory Authority's plans to incorporate sustainable practices into their work.

Moreover, eco-labelling initiatives exist in France, Germany, Luxembourg, the Nordic countries (Denmark, Sweden, Finland, plus non-EU Iceland and Norway) and Austria. Apart from Austria's, the other four initiatives are based on taxonomies:[5]

- the TEEC Label (France) and the FNG Siegel (Germany) are based on the CBI taxonomy;
- the Luxflag Climate Finance Label (Luxembourg) is based on the IDFC taxonomy;
- the Nordic Swan Ecolabel is based on the ICMA's Green Bond Principles.

In each case, the taxonomies have been adjusted to reflect national priorities and have also been narrowed down or made more granular for certain sectors.

In addition to these taxonomies, there are other initiatives at international level:

- China has developed the China Green Bond Endorsed Project Catalogue, based on a taxonomy organised in three levels of categories.
- Since 2007, FTSE Russell and Impax Asset Management have been developing the Environmental Markets Classification System (EMCS), which can be applied globally.

Parliament's starting position

On 29 May 2018, the European Parliament adopted a resolution in response to the action plan on sustainable finance. Members of the European Parliament largely supported the Commission's initiative, agreeing on the essential need to define an EU sustainability taxonomy.

The European Parliament called on the Commission to lead a multi-stakeholder process, including both climate-science experts and financial-sector participants. The purpose of this process would be to establish, by the end of 2019, a robust, credible and technology-neutral sustainability taxonomy, based on indicators that disclose the full impact of investments on sustainability and allow the comparison of investment projects and companies.

The Parliament emphasised the need to develop such sustainability indicators as a first step in the process of developing an EU sustainability taxonomy, and to incorporate these indicators into integrated reporting. MEPs supported the approach of introducing a comprehensive framework, the details of which should be phased in through specific legislative initiatives.

Furthermore, MEPs stressed that such a framework should – through its political, supervisory and regulatory components – take into account the diverse opportunities of EU regions. Last but not least, MEPs highlighted that the EU currently lacks a unified standard for green bonds,[6] and that such a standard should be founded on the forthcoming EU sustainability taxonomy.

Preparation of the proposal

In December 2016, the Commission established a high-level expert group (HLEG) to develop a comprehensive EU strategy on sustainable finance. In July 2017, the expert group published an interim report, which was followed by a public consultation.

On 31 January 2018, the HLEG published its final report, in which it made eight key recommendations for creating a sustainable European financial system. One involves creating a technically robust EU-level classification system to provide clarity on what is 'green' or 'sustainable'. A first step in this direction would be to establish when an economic activity can be considered environmentally sustainable.

On 8 March 2018, on the basis of the HLEG final report, the Commission published its action plan on financing sustainable growth and a call for applications for the selection of the members of a technical expert group on sustainable finance. Set up on 13 June 2018, this group will assist the Commission in implementing the said action plan. One of its main tasks is to put together an EU taxonomy of environmentally sustainable economic activities.

On 24 May 2018, according to the priorities set in the action plan, the Commission published a first package of three proposals. Proposal COM(2018) 353 addresses the need for a unified EU classification system of sustainable economic activities (taxonomy). Proposal COM(2018) 354 aims to increase the transparency duties of financial intermediaries towards final investors, both with regard to sustainability risks and to the sustainable targets of their investments. Proposal COM(2018) 355 creates a new category of benchmarks that will help investors compare the carbon footprint of their investments. The package is accompanied by an impact assessment covering all three proposals. EPRS has prepared an initial appraisal of that impact assessment.

The present proposal for a regulation builds on the HLEG's final report and on a study entitled Defining 'green' in the context of green finance, ordered by the Commission in 2017, and presenting an overview of worldwide efforts to define 'green' in the context of green bonds, lending and listed equity.

The changes the proposal would bring

The proposed regulation would launch a gradual process for the establishment of a uniform EU framework of criteria, which would be used to classify the environmental sustainability of economic activities.

This process would involve the cooperation of the Commission with a broad range of stakeholders, in order to define the taxonomy framework and to keep it evolving in step with the rapidly evolving concept of sustainability. The taxonomy would be developed through delegated acts.

The proposal would not establish a label for sustainable financial products, but would allow Member States to keep their labelling schemes in place and/or to further develop them. On the other hand, it would provide the framework of criteria to comply with when defining environmentally sustainable economic activities and setting up such labels at national or EU level.

An economic activity would be considered environmentally sustainable if it complies with all four criteria identified in Article 3:

- the activity should 'contribute substantially' to one or more environmental objectives (listed in Article 9);
- the activity should not 'significantly harm' any of the environmental objectives;
- the activity should be carried out in compliance with minimum international social and labour standards;[7]
- the activity should comply with technical screening criteria, adopted by the Commission through delegated acts.

Article 9 focuses on the first and second criteria of Article 3, by listing the six environmental objectives that should be considered for the purpose of the proposed regulation: 1) climate change mitigation; 2) climate change adaptation; 3) sustainable use and protection of water and marine resources; 4) transition to a circular economy; 5) pollution prevention and control; and 6) protection and restoration of biodiversity and ecosystems.

Articles 10 to 15 zoom in on the concept of 'substantial contribution' referred to in Article 3(a), and describe how it would be applied for each of the six environmental objectives. Furthermore, for each objective, these articles set a timeline for the Commission to adopt the relevant delegated act and ensure its entry into application, starting with the objectives of climate change mitigation and climate change adaptation.

Article 17 defines the concept of 'significant harm' referred to in Article 3(b), while Article 18 defines the minimum safeguards referred to in Article 3(c).

The Commission, through the adoption of delegated acts, would specify the technical screening criteria referred to in Article 3(d). Such criteria would define what qualifies as a substantial contribution to a given environmental objective and to what extent, and what should be considered as posing significant harm to the objective. The general requirements for these technical screening criteria are set in Article 19. One relevant requirement is the analysis by the Commission of the potential impact of these criteria on the evaluation of assets. It would be assessed whether these criteria would give rise to stranded assets[8] and to the risk of delivering inconsistent incentives.

Article 16 contains a definition of the platform on sustainable finance which would be established. This platform would consist of experts advising the Commission on the development and evolution of the regulation. The experts would support the Commission in defining the technical screening criteria and their updates, and advise the Commission on the possible need to amend the regulation.

Advisory committees

The European Economic and Social Committee (EESC) adopted an opinion in October 2018, in which it addressed the proposals in COM(2018) 353 and COM(2018) 355. It pointed out that the taxonomy, where possible, should be based on existing international frameworks. It further highlighted that in the future, the system should be extended to social sustainability and governance goals. Moreover, it advised taking into account the differences between the individual sectors and the size of businesses when developing the taxonomy. Last but not least, it advised that information to and communication with all stakeholders, operational businesses and the general public be developed through a plan, which would include aspects of financial education and training, among other things.

During its October 2017 plenary session, the Committee of the Regions had adopted an opinion – Climate finance: an essential tool for the implementation of the Paris agreement – highlighting the role of local and regional governments in supporting investments aimed at achieving the objectives of the Paris Agreement.

Stakeholder views[9]

The European Banking Federation (EBF), in its position paper suggests that the taxonomy should be seen as the common language for all market participants to be used in all their activities on a voluntary basis. Furthermore, the EBF recommends that the proposed regulation should elaborate on existing market practices and industry codes, where possible, to enable automation of the processes and consistent reporting amongst stakeholders.

The European Fund and Asset Management Association (EFAMA) welcomed the Commission proposal, while at the same time providing a number of recommendations. One such recommendation is that the taxonomy should look beyond impact investments[10] and should include different ways of tackling environmental, social and governance (ESG) factors. Another is that the taxonomy should also consider 'transition' investments[11] and take into account the cross-border nature of investments. Finally, EFAMA asks for a longer implementation phase.

Finance Watch, in its comments to the final HLEG report, highlights that positive criteria should be complemented by negative ones, in order to better identify non-sustainable assets.

Better Finance, in its feedback on proposal COM(2018) 353, suggests that the Commission should concurrently develop the criteria/taxonomy for the three components of the 'ESG' consideration. Furthermore, the taxonomy should be developed in a timely fashion to allow for it to serve as a pillar in the implementation of the proposal for disclosures (COM(2018) 354) and the proposal for low carbon benchmarks (COM(2018) 355).

Legislative process

The legislative proposal (COM(2018) 353) was presented on 24 May 2018. It falls under the ordinary legislative procedure (2018/0178(COD)). In the European Parliament, the dossier was initially assigned to the ECON committee, which nominated Bas Eickhout (Greens/EFA, the Netherlands) as rapporteur. On 13 November 2018, Parliament announced that it would apply Rule 55 of its Rules of Procedures (joint committee procedure) to the dossier, and assigned it jointly to ECON and ENVI. Sirpa Pietikäinen (EPP, Finland) was then nominated as co-rapporteur. The BUDG, ITRE and IMCO committees decided not to give opinions. On 11 March 2019, the joint committee adopted its report. On 28 March 2019, the Parliament voted to adopt its position at first reading. On 25 September 2019, the Council agreed its position on the dossier. After interinstitutional negotiations, on 17 June 2020, the Parliament adopted the compromise text at second reading. The final act was signed on 18 June and published in the Official Journal on 22 June. It applies as of 12 July 2020, although certain provisions apply in full only as of January 2022 or January 2023.

Parliament position

Parliament welcomed the Commission legislative proposal while calling for a number of changes. It demanded a gradual shift of private investments from activities with negative environmental impact towards more sustainable activities. In addition, it advocated gradually harmonising at EU level criteria and indicators for determining the degree of environmental sustainability of an economic activity. Those criteria and the set of harmonised indicators should be reasonable, proportionate and ensure coherence with existing Union legislation. Furthermore, they should take into account the impact on the entire industrial value chain and the life-cycle of technologies. The adopted text proposed that the application of this regulation should be reviewed regularly and at least after two years. Lastly, by 31 December 2021, and subsequently every three years thereafter, the Commission should review whether the regulation creates excessive administrative burden or if the necessary data for financial market participants are insufficiently available.

Council position

In its proposal, the Council advocated that large companies, which are subject to an obligation to publish non-financial information pursuant to Article 19a or Article 29a of Directive 2013/34/EU, would have to report in their non-financial statements or consolidated non-financial statements on certain climate-related key performance indicators that are based on the framework established by the Taxonomy Regulation. The Council also asked to involve experts representing both the public and private sectors, as well as civil society in the Platform on Sustainable Finance. With regard to technical screening criteria, the Council recalled the principle of technological neutrality.[12] Furthermore, the Council asks that power generation activities which use solid fossil fuels should not qualify as environmentally sustainable economic activities. Furthermore, the Council text lays down requirements for transitional and enabling activities.

Interinstitutional agreement

The compromise text includes a number of changes to the Commission's initial proposal.

In article 1, the application of the regulation has been extended to undertakings which are subject to the obligation to publish a non-financial statement or a consolidated non-financial statement.

In article 4, the use of the criteria for environmentally sustainable economic activities has been broadened from Member States (Commission proposal) to Member States and the Union (adopted text).

Four articles on transparency have been added: article 5 on transparency of environmentally sustainable investments in pre-contractual disclosures and in periodic reports, article 6 on transparency of financial products that promote environmental characteristics in pre-contractual disclosures and in periodic reports, article 7 on transparency of other financial products in pre-contractual disclosures and in periodic reports, article 8 on transparency of undertakings in non-financial statements.

The new article 16 introduces the concept of 'enabling activities', which are those activities contributing substantially to one or more of the environmental objectives by directly enabling other activities to make a substantial contribution to one or more of those objectives.

In article 17, the scope of assessing when an economic activity significantly harms environmental objectives has been broadened. Both the environmental impact of the activity itself and the environmental impact of the products and services provided by that activity throughout their life cycle should now be considered.

In article 20, where the composition of the Platform on Sustainable Finance is defined, further members have been included. More than those mentioned in the Commission proposal, the Platform should include representatives of the European Union Agency for Fundamental Rights, experts representing civil society, as well as experts representing academia. The same article broadens the Platform's mandate, by adding new tasks.

The new article 24 introduces the Member State Expert Group on Sustainable Finance, which should advise the Commission on the appropriateness of the technical screening and the approach taken by the Platform. The Commission shall inform the Member States through meetings of the Member State Expert Group to facilitate and exchange of views.

EP SUPPORTING ANALYSIS

S. Vettorazzi, An EU framework to facilitate investments in environmentally sustainable economic activities, initial appraisal of the Commission IA accompanying the legislative package, EPRS, European Parliament, April 2019.

OTHER SOURCES

Framework to facilitate sustainable finance, European Parliament, Legislative Observatory (OEIL).

European Parliament, resolution of 29 May 2018 on sustainable finance (2018/2007(INI)).

High-Level Expert Group on Sustainable Finance, final report, 31 January 2018.

High-Level Expert Group on Sustainable Finance, Informal supplementary document on sustainable taxonomy, 31 January 2018.

Technical Expert Group on Sustainable Finance (TEG), Spotlight on Taxonomy.

European Political Strategy Centre, Financing Sustainability: Triggering Investments for a Clean Economy, 8 June 2017.

European Investment Bank, Green Finance Committee of China Society for Finance and Banking, White Paper 'The need for a common language in Green Finance', 11 November 2017.

ENDNOTES

1 The practice of financial products being marketed as 'green' or more generally 'sustainable', when in fact they do not meet basic environmental standards. Diverging classifications of economic activities that have varying scopes and are based on different criteria and metrics leave a lot of scope for greenwashing. The latter has a direct negative effect on the functioning of the internal market, as it undermines investor confidence in the market for sustainable investments (source: Frequently asked questions: Commission proposals on financing sustainable growth).

2 The estimate is a yearly average investment gap for the period 2021 to 2030, based on PRIMES model projections used by the Commission in its impact assessment of its proposal for an energy efficiency directive (2016), SWD(2016) 405.

3 Environmental Finance, 'Most parts of EU's action plan rely on a clear taxonomy, Dombrovskis says', 21 March 2018.

4 As of June 2017, institutional investors and asset managers in France must disclose how their business strategies cover climate change. The new obligation derives from Article 173 of the 2015 French Energy Transition Law, which requires institutional investors to publish their contribution to the fight on climate change, and to cover climate-related risks in their annual reports.

5 The Climate Bonds Taxonomy was produced by the Climate Bonds Initiative (CBI) to notably certify climate and green bond issuances. The Common Principles for Climate Change Mitigation and Adaptation Finance Tracking were produced by the International Development Finance Club (IDFC) and a number of multilateral development banks for their lending to climate-related investments. The Green Bond Principles were produced by the International Capital Markets Association (ICMA). The Austrian Ecolabel only specifies exclusion criteria but does not stipulate the use of a specific taxonomy.

6 A green bond is a bond specifically earmarked to be used for climate and environmental projects. Such bonds are typically asset-linked and backed by the issuer's balance sheet, and are also referred to as climate bonds. More information on the World Bank's website.

7 This criterion recognises the relevance of international minimum human and labour rights and standards. Compliance with minimum safeguards would be a condition for economic activities to qualify as environmentally sustainable. The activities should be carried out in observance of the International Labour Organization's (ILO) Declaration on Fundamental Rights and Principles at Work and the eight ILO core conventions. Several of these international standards are also enshrined in the Charter of Fundamental Rights of the European Union. This criterion also recalls the principles enshrined in the European Pillar of Social Rights.

8 'Stranded assets' are assets that have suffered from unanticipated or premature write-downs, devaluations or conversion to liabilities. They can be caused by a range of environment-related risks. For more information, see the *Journal of Sustainable Finance & Investment*.

9 This section aims to provide a flavour of the debate and is not intended to be an exhaustive account of all different views on the proposal. Additional information can be found in related publications listed under 'EP supporting analysis'.

10 Impact investment means investing with the intention to generate measurable environmental and social impact alongside a financial return.

11 The focus should be on investments in the transition to a low-carbon economy, rather than investments that are already fully sustainable.

12 Technology neutrality means that technical standards designed to limit negative externalities (e.g. pollution) should describe the result to be achieved, but should leave freedom to adopt whatever technology is most appropriate to achieve the result. The Council has decided to maintain the principle of technological neutrality in its position, despite calls from Austria, Germany, Greece, and Luxembourg to explicitly exclude nuclear from the classification scheme for investment in sustainable energy projects.

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