

ANALYST INSIGHT

# T is for... Taxonomy



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## ABSTRACT

**The EU Taxonomy classifies and clearly identifies sustainable economic activities, helping investors grow the clean economy and improve the footprint of today's activities while supporting EU rules to define "green investment" consistently.**

**THE DICTIONARY** provider Merriam-Webster defines<sup>1</sup> taxonomy as the study of the general principles of scientific classification (systematics), or –especially– an orderly classification and study of [organisms] with regard to their presumed natural relationships.

Last month the EU-appointed Technical Expert Group on sustainable finance issued several reports, one of which proposes an EU classification system –the so-called EU taxonomy<sup>2</sup>– to determine whether an economic activity is environmentally sustainable.

### WHY A TAXONOMY?

To achieve the Paris Agreement commitments, Sustainable Development Goals (SDGs) as well as other EU's environmental goals, public sector finance alone will not be enough: additional substantial investments are needed, hence mobilising and re-directing private capital is necessary.

For the EU's climate goals alone, it is estimated that an additional annual private injection of €175 to 290 billion is required: this creates opportunities for investments and projects, but investors

need clear information and useful tools if they are going to react to these opportunities.

In March 2018 the European Commission adopted an action plan on sustainable finance<sup>3</sup>. It has 3 main objectives :

1. Channel capital flows towards sustainable investment, in order to achieve sustainable and inclusive growth
2. Manage financial risks stemming from climate change, environmental degradation and social issues
3. Foster transparency and long-termism in financial and economic activity

At the top of initiatives included in the Action Plan was "Establishing an EU Classification System For Sustainability Activities", leading to the development of an EU taxonomy for climate change, environmentally and socially sustainable activities, with reports from a technical expert group providing a taxonomy of climate change mitigation, adaptation and other environmental activities by Q2 2019.

The EU Taxonomy is therefore a classification tool to help investors and companies identify (in a consistent way) environmentally friendly economic activities. It can help to grow the future clean economy and the hope is also to substantially improve the environmental performance of today's activities.

Besides, in its final form it will provide a framework for various EU rules aiming to make "green investment" a consistent field.

Detailed assessments of the various sectors' contributions to fighting climate change are drawn up in the document, making it a hefty compendium: the link to the report encourages "(...) readers not to print this report as it is 414 pages long)". You have been warned!

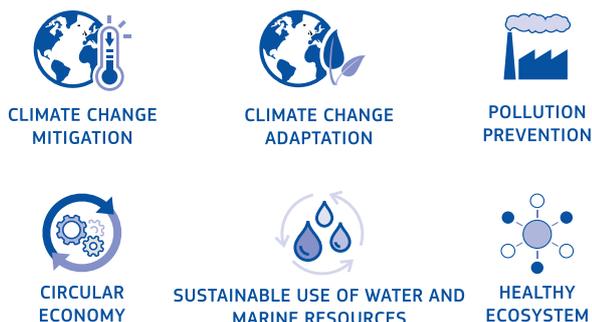
### WHAT ENVIRONMENTAL OBJECTIVES?

<sup>1</sup> Merriam-Webster Online. (2019). [Taxonomy definition](#)

<sup>2</sup> European Commission. (2019). [EU taxonomy for sustainable activities](#)

<sup>3</sup> European Commission. (2018). [Action Plan: Financing Sustainable Growth](#)

Economic activities considered to be included in the proposed EU Taxonomy must “contribute substantially” (screening criteria may include quantitative or qualitative thresholds) to at least one environmental objective and “do no significant harm” (DNSH) to the other five, as well as meet minimum social safeguards. The six Taxonomy environmen-



tal objectives are:

At this stage, the TEG report concentrated mostly on the climate change objectives (mitigation + adaptation).

### Mitigation:

To grow the low-carbon sector, encourage sequestration, decarbonise existing industry and avoid promoting activities which are incompatible with climate mitigation goals, the EU Taxonomy will consider three kinds of activities as making a substantial contribution to climate change mitigation:

1. Activities that are already low carbon, a.k.a. ‘green’ (i.e. activities associated with sequestration or very low and zero emissions, e.g. Zero emissions transport; Near to zero carbon electricity generation; Afforestation). They require capital for development and deployment. Technical screening criteria for these activities are likely to be stable and long-term.
2. Activities that contribute to a transition to a net-zero emissions economy in 2050 but are not currently close to a net-zero carbon emissions level, a.k.a. ‘greening of’ (e.g. Build-

ing renovation; Electricity generation <100g CO<sub>2</sub>/kWh ; Cars <50g CO<sub>2</sub>/km) They are critical to the economy but must significantly enhance their performance beyond current industry average, without lock-in to carbon intensive assets or processes. Technical screening criteria for these activities will be subject to regular revision, approaching zero over time.

3. Activities that enable low carbon performance or enable substantial emissions reductions, a.k.a. ‘greening by’ (e.g. Manufacture of wind turbines ; Installing efficient boilers in buildings). Technical screening criteria will depend on their current emission performance.

### Adaptation:

Economic activities can contribute to adaptation objectives in two different ways:

1. Adaptation of an economic activity: it is made more climate resilient by integrating measures to reduce all material physical climate risks to the extent possible and on a best effort basis;
2. Adaptation by an economic activity: it contributes to adaptation of other economic activities to physical climate risks and must also be resilient to physical climate risks itself.

Investors should look for implementation of three principles to understand whether an activity makes a substantial contribution to climate change adaptation:

**Principle 1:** The economic activity reduces all material physical climate risks to the extent possible and on a best effort basis. The activity must integrate measures aimed at reducing all material physical climate risks posed by current weather variability and future climate change, or it must reduce material risks to other economic activities and/or address systemic barriers to adaptation.

**Principle 2:** The economic activity does not adversely affect adaptation efforts by others. Activi-

ties should be consistent with adaptation needs in the applicable sector or region. Adaptation activities should not hinder adaptation by others.

**Principle 3:** The economic activity has adaptation-related outcomes that can be defined and measured using adequate indicators. When possible, the outcomes of adaptation activities should be monitored and measured against defined indicators for adaptation results.

**WHAT PERIMETER?**

The macro-economic sectors analysed by the Taxonomy were selected based on quantitative data on GHG emissions in the EU. Sectors with a high potential to enable substantial GHG emissions reductions in other sectors have also been included. The TEG analysed a total of six macro-sectors for climate change mitigation based on GHG emissions as well as one enabling sector. In total the activities in the selected sectors represent 93.2% of GHG emissions by NACE code as well as a significant proportion of GDP and total employment at the EU level.



Across the sectors, technical screening criteria for 67 activities and potential contribution to climate change mitigation are proposed. For instance, Agriculture and Forestry is further analysed as follows:

Agriculture and Forestry	Can climate change mitigation criteria change in future?	Do No Significant Harm criteria identified?				
		Adaptation	Water	Circular economy	Pollution	Ecosystems
Growing of perennial crops	✓	✓	✓	✓	✓	✓
Growing of non-perennial crops	✓	✓	✓	✓	✓	✓
Livestock production	✓	✓	✓	✓	✓	✓
Afforestation		✓	✓			✓
Rehabilitation, Restoration		✓	✓			✓
Reforestation		✓	✓			✓
Existing forest management	✓	✓	✓			✓

Finally, the last (and longest) part of the report provides a full list of sector- and economic activity-specific technical screening criteria and rationale for the TEG’s analysis.

**WHAT EFFECTS?**

The taxonomy follows the latest EU climate & environmental goals (including climate neutrality by 2050, i.e. net-zero GHG emissions), for which implementation requires transformative shifts for many sectors in the economy. It helps translate those goals into investment practice, clearly outlining activities that are consistent with EU environmental objectives: it clearly shows that some currently mainstream sectors must evolve drastically to stay in the Taxonomy club, which will raise the bar for membership of the transition activities.

With this framework in place, when marketing investment products as “green” or environmentally sustainable, financial intermediaries would need to explain whether they have used the Taxonomy criteria, and how. Investors could express their preference for investments in Taxonomy-eligible activities or for their own approach to determine that their investment is environmentally sustainable.

**WHO IS CONCERNED?**

The taxonomy outlines benefits to financial markets participants, (e.g. banks, insurers, fund managers), by facilitating the identification of sustainable assets and consequently the integration of sustainability factors in their investment decisions. The taxonomy should also encourage the incorporation of sustainability concerns by corporations and investees into their strategy, providing an opportunity to diversify its investor base and

more certainty on the transition path. The main costs derived from the implementation of the taxonomy relate to the collection and management of data needed to check performance in the defined screening criteria : even with a taxonomy in place, achieving reliable consistency will take time...

The TEG expects retail consumers to benefit from more transparency, easier access to green products (with reduced risk of greenwashing) and better comparability. Finally, regulators and supervisors could leverage the taxonomy to implement new green investment frameworks at a lower cost. The actual impacts may vary significantly depending on several factors, the adoption of related regulatory actions (e.g. mandatory integration of ESG considerations into the investment and advisory process) and the level of appropriation of the taxonomy by the private sector, at the same time depending on its usability and dynamism. Disclosure obligations will link to the taxonomy, but optional additional uses could also accelerate its adoption.

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### HOW MUCH FUNDING, THEN?

The impact assessment of the taxonomy builds upon the existing estimates regarding the investments needs to achieve targets associated with the low carbon transition and other sustainability objectives.

The analysis takes into consideration the current significant exposures of institutional investors to climate policy relevant sectors in the equity and bond markets.

The estimated impact on financial markets of filling the investment gap varies across sectors and scenarios. Nevertheless, the increased financial investments towards relevant sectors generally seem achievable, at least under the least stringent scenarios, compared to the current size of the corporate bond market and outstanding loans to non-financial corporations ; even in the most strin-

gent scenario, estimates show that the (green) bond and loan issuance would increase by around 4.9% in the energy-intensive sector and by 6.0% in the transport sector. It thus appears likely that filling the gap is compatible with a modest/reasonable increase of a) the leverage of relevant sectors and b) the exposure of institutional investors, via bond holdings and loans, to firms in said sectors.

### WHAT'S NEXT?

A call for feedback is active until 13 September 2019 and topics for comments are : the proposed climate change mitigation activities, climate change adaptation principles and criteria, usability of the proposed taxonomy and future development of the taxonomy.

Presently the report covers activities that make a substantial contribution to climate change mitigation and adaptation. Further activities will be added in the future, including some contributing significantly to other environmental objectives.

### OTHER FALLOUTS?

In any game, it generally pays to be on the side of those writing the rules (remember the impact of IFRS on continental EU financial institutions?). In this instance, once the Taxonomy is up and running it might inspire non-EU investors to adopt it: that could help to foster a truly global approach to sustainable investment in order to solve global problems, which would be no bad thing. 

Sources: BR research, Technical expert group on sustainable finance (TEG), European Commission,

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