A legal framework for defining green finance

The EU taxonomy

SOMO Fact Sheet | December 2020

Why did the EU introduce a new finance law about environmental definitions?

In order to encourage more financing of activities and companies that support the EU's attempt to meet the climate targets of the Paris Agreement, the EU has been implementing an Action Plan on Financing Sustainable Growth. A key component of the Action Plan has been the introduction of a new sustainable finance law, the Taxonomy Regulation, as explained in this fact sheet.

A significant obstacle in so-called 'green finance' has been that investors have had no clear definition for how specific economic activities or companies prevent – or contribute to – climate change and environmental degradation, or adapt to climate change impacts. The European Commission (EC) therefore made a legislative proposal for an EU 'taxonomy' in May 2018 to define and categorise economic activities that are sustainable with regard to climate and the environment. The proposal was catalysed by the concern of the EC, among others, that investment products (e.g. green bonds as well as investment funds that integrate shares) continue to be marketed as green or climate friendly although the companies and their activities do not contribute effectively or positively to climate mitigation, climate adaptation or environmental resilience. By establishing clear EU definitions of what 'green' entails, the law is intended to prevent such 'greenwashing' by the investment industry and to promote trust in green investment products that voluntary adopt the official EU definitions.

On 12 July 2020, the Taxonomy Regulation entered into force in all EU member states. This EU law is a "framework to facilitate sustainable investment". As explained below, it provides basic definitions and criteria for the establishment of six broad categories of 'environmentally sustainable economic activities' for financing. In addition, the law sets out the processes through which each of these activities (e.g. within the agricultural or energy sector) will be defined in detail according to the criteria and decided on between December 2020 and January 2023.

During the legislative process, the draft Taxonomy Regulation provoked fierce lobbying by the financial sector and energy companies. The European Parliament and the EU Council of Finance Ministers strongly disagreed before compromising on a final legal text. Some of the controversies that will continue to be thorny issues in the coming years include the following: voluntary adherence (private investors are not compelled to align with the taxonomy); whether or not to include nuclear energy and gas in the definitions of 'environmentally sustainable'; the lack of information

by companies about their environmental, social and governance (ESG) impacts; the absence of definitions for what is harmful to the climate or what is socially beneficial; and the level of influence by member states and corporations in upcoming decisions.

This fact sheet explains what the Taxonomy Regulation covers and what is still be decided upon before the end of 2022. It also points out some of the loopholes and critiques of the law.

The EC's explanation of the Regulation on the Establishment of a Framework to Facilitate Sustainable Investment, in short the Taxonomy Regulation, can be found here.

The Taxonomy Regulation is one of the three sustainable finance laws and initiatives in place as part of the implementation of the Action Plan on Sustainable Finance. The 2019 EU Regulation on how investors should disclosure their sustainability assessments (SFDR or Sustainability-related Disclosures in the Financial Services Sector Regulation, previously referred to as DSR) was amended by the new taxonomy law, as explained below. The third new sustainable finance law, agreed in 2019, is the Regulation that defines EU standards for 'Paris-aligned benchmarks', 'climate transition benchmarks', and sustainability-related disclosures for benchmarks (Benchmark Regulation).

New legislative proposals on sustainable finance in the context of the EU Green Deal and various applications of the taxonomy are expected from beginning of 2021 onwards, after the EC has proposed its Renewed Sustainable Finance Strategy.

Which 'environmentally sustainable activities' are defined in the EU taxonomy?

The Taxonomy Regulation introduces official EU definitions for six categories of 'environmentally sustainable economic activities' that have a positive impact on tackling climate change and environmental degradation.

Investors or investment products that claim to be in accordance with the taxonomy will need to fulfil a series of conditions (Art. 3) set out in the law as explained below.

The taxonomy has **six categories** (Art. 9) of environmentally sustainable economic activities that must comply with the following environmental objectives:

1 Climate change mitigation (defined in Art. 10);
2 Climate change adaptation (defined in Art. 11);
3 Sustainable use and protection of water and marine resources (defined in Art. 12);
4 Transition to a circular economy (defined in Art. 13);
5 Pollution prevention and control (defined in Art. 14);
6 Protection and restoration of biodiversity and ecosystems (defined in Art. 15; this also includes forests);

Each of these categories is defined in broad terms in an article in the legal text, sometimes with reference to existing EU environmental laws with the same objectives.

In addition, the taxonomy includes definitions of:

7 Transitional activities (Art. 10.2., 26.2.a); and
8 Enabling activities (Art. 16, 26.2.a), defined as those that substantially contribute to achieving one or more of the environmental objectives above (1-6) while not locking in assets that undermine the long-term environmental goals.

The Taxonomy Regulation also provides for the addition of activity categories covered by the law. According to Art. 26.2, the EC must publish a report by 31 December 2021 that describes how the Taxonomy Regulation can **extend** its scope to include activities that:

9 '**Significantly harm** environmental sustainability' (known as 'brown taxonomy'), or 'do not have a significant impact on environmental sustainability';
10 Have **social or other sustainability objectives**.

What are the basic requirements for each defined activity?

In order to be defined as an 'environmentally sustainable economic activity' in one of the six categories of the taxonomy mentioned above, economic activities must meet *all* of the following **requirements and criteria**:

- ☐ They must **contribute substantially** to one or more of the six environmental objectives;

- ☐ They must **Do No Significant Harm (DNSH)** to any of the other six environmental objectives in the taxonomy. Significant harm is defined in broad terms in Art. 17 (e.g. an activity that 'leads to significant greenhouse gas emissions');

- ☐ They must comply with **minimum social safeguards** (Art. 18) through procedures that ensure the alignment with:
  - The OECD Guidelines for Multinational Enterprises;
  - The UN Guiding Principles on Business and Human Rights;
  - The labour rights set out in the eight fundamental conventions identified in the International Labour Organisation's Declaration on Fundamental Principles and Rights at Work;
  - The International Bill of Human Rights.

The implementation of these minimum social safeguards must adhere to the **principle of 'do no significant harm'** to sustainability objectives including tackling inequality, 'labour relations' and fostering social cohesion, as defined in Art. 2 (17) of SFDR and decided by the EC after 30 December 2020.

- They must comply with **technical screening criteria** specific to each activity.

How should technical screening criteria be applied?

Each economic activity within a particular economic sector (e.g. agriculture or transport) can only be defined as environmentally sustainable in compliance with the taxonomy, after having been screened and found to comply with specified technical requirements (Art. 19). These required technical screening criteria must, amongst others:

- be based on conclusive scientific evidence and the precautionary principle (EU Treaty Art. 191);
- be quantitative, with thresholds and based on certification where possible, or otherwise be qualitative;
- identify the most relevant potential contribution to the environmental objective;
- cover all relevant economic activities within a specific economic sector;
- be easy to use and verify;
- exclude the use of 'solid fossil fuels' (i.e. coal) for power generation.

The EC will need to review these legally binding technical screening criteria at least every three years, and can amend them to ensure the transition to a 'climate-neutral economy'.

How are the technical definitions for climate mitigation and adaption activities decided upon?

In order to speed up the implementation of the Taxonomy Regulation, the EC established a Technical Expert Group (TEG) back in July 2018 to start elaborating the detailed definitions according to the proposed taxonomy's legal requirements and criteria regarding categories 1 and 2 above. Although the TEG consisted of a variety of stakeholders, a majority of its representatives were from the financial industry. Following a public consultation, the TEG final advisory report was published on 9 March 2020. The report's 593-page technical annex defines in detail 70 climate change mitigating activities and 68 climate change adaptation activities in various economic sectors (e.g. forestry, manufacturing, etc.). It also provides practical tools for how to apply the technical screening criteria.

The TEG did not define activities under the other four categories (3-6 above). One of its recommendations regards an EU Standard for Green Bonds that should cover activities according to the taxonomy.

The TEG report was submitted as advice to the EC, which in turn must ultimately decide on the EU's list of legally binding and technically detailed definitions of climate mitigation and climate adaptation activities. The TEG's mandate ended on 30 September 2020.

When and how will the EC decide on the detailed definitions?

The EC has the decision-making power – through 'delegated acts' – to define the details of each of the environmentally sustainable economic activities (e.g. building renovation) within particular economic sectors (e.g. construction) as being in compliance with the Taxonomy Regulation's requirements and criteria. It is expected to gather expertise and advice, amongst others from expert groups (see below). Public consultations will also be held prior to EC decisions to allow comments on draft delegated acts. These public consultations will be online and accessible to all, generally for a period of four weeks. Once issued by the EC, the delegated acts can be rejected by the European Parliament and/or the EU Council of Ministers within four months of the EC's decision (Art. 23).

Regarding the list of specific climate change mitigation and adaptation activities aligned with the taxonomy law (categories 1 and 2 above), the EC draft delegated act was published on 20 November 2020 for a four week consulation with two annexes that follow more or less the TEG's technical definitions. However, fierce discussion and lobbying continue in the run-up to the EC's decision, for instance on whether or not to include nuclear energy and gas. The Taxonomy Regulation stipulates that the EC must decide on this delegated act to define climate change and mitigation activities by 31 December 2020. These definitions will then fully apply from 1 January 2022.

Activities that comply with the remaining four environmental categories (3-6 above) will be decided on by 31 December 2021 through upcoming EC delegated acts so that they are fully applicable from 1 January 2023. The EC's decision will follow public consultations and consultation with the Platform on Sustainable Finance and the Member States Expert Group on Sustainable Finance.

What are the roles of the Platform on Sustainable Finance and the Member States Expert Group?

The Taxonomy Regulation requires the creation of a Platform on Sustainable Finance (Art. 20). The role of this Platform is manifold, and includes advising the EC on:

- The implementation, impact, improvement and revision of the technical screening criteria;
- Trends in capital flowing into sustainable investment;
- Related accountancy issues;
- Improving data availability and quality;
- The application of the minimum safeguard measures;
- Extending the taxonomy law to categories with harmful activities and social or other sustainability objectives;
- Amending the Taxonomy Regulation; and
- Policy coherence.

The Platform was established on 1 October 2020. Earlier, the EC had issued a call for expressions of interest and based its membership selection upon the more than 500 responses. The taxonomy law requires that its members come from various EU bodies, including supervisory authorities, and that it also includes stakeholders from different business sectors, civil society and the research community. The list of members now shows 51 stakeholder representatives from different business sectors and associations (many of which play a role in climate change), NGOs (15 in total) and research institutes. The EC has appointed Nathan Fabian – Chief Responsible Investment Officer at Principles for Responsible Investment (PRI) and formerly active in both the TEG and the High Level Expert Group on Sustainable Finance – as chair of the Platform.
The members are divided into different working groups, and according to the EC "will reach out to a wide range of stakeholders through both public consultations and targeted outreach". This outreach will include the scientific community. Minutes from the Platform's meetings are required to be posted on the EC website to ensure transparency.

The Member States Expert Group on Sustainable Finance has already been established according to Art. 24. It allows EU member state representatives to have timely exchanges of views and to advise the EC on the criteria for the definitions, as well as on the Platform's outputs and its approach to the technical screening criteria.

The EC will assess (Art. 26.3.) the effectiveness of these two advisory instruments after the Taxonomy Regulation has been in force for two years (by 13 July 2022).

How will the taxonomy's definitions be applied and supervised?

The application of the taxonomy is **voluntary** for the private financial sector. This means that no investor or investment product is compelled to abide by the taxonomy. It is only used when an investor or an investment product claims to finance one or more 'environmentally sustainable' economic activities that meet all of the taxonomy's criteria, standards and requirements. When investors or investment products claim some aspect of sustainability yet fail to adhere fully to the taxonomy, they must report what portion of the investments underlying the financial product do or do not comply with the taxonomy's criteria (Art. 5, 6; see also section on SDFR below).

The use of the taxonomy is **compulsory** for the EU and member states when introducing requirements and standards regarding environmental sustainability of financial products, such as an EU ecolabel for investment products or an EU Green Bond Standard (Art. 1, 4). It will also apply to some activities financed by the EU recovery funding related to COVID-19. It does not apply to member states that already have a system of tax waivers for sustainable financial products in place (Art. 27).

The taxonomy does not yet have to be applied to bank loans and other credit provisions.

The supervision and enforcement of the Taxonomy Regulation will be done by national supervisory authorities that oversee the different kinds of investment products covered by 10 EU investment laws (Art. 21, Preamble 55). EU member states must provide these bodies with the necessary investigative powers and capacity to detect misleading claims about the taxonomy in investment products. Member states must also establish the rules for effective measures and penalties to deal with taxonomy law infringements (Art. 22).

The Taxonomy Regulation must be evaluated by 12 July 2022, and every three years thereafter. The reviews will include an assessment of the application of the screening criteria and the need to revise them; the effectiveness of the taxonomy in increasing sustainable investments; and the verification mechanisms (Art. 26).

How will transparency and reporting requirements for investors and companies align with the taxonomy?

While the application of the taxonomy by the private financial sector is voluntary, the taxonomy law imposes disclosure obligations.

Any investment product must be transparent whether or not it meets the environmentally sustainable objectives and criteria of the taxonomy. To ensure this, the Taxonomy Regulation has introduced the following **amendments to the EU Regulation on Sustainability-related Disclosures in the Financial Services Sector** (SDFR, 2019):

- All financial products with investments claiming to have sustainable objectives or characteristics, must disclose how they align with the taxonomy (Art. 25). The information provided should specify what share of the investment is aligned with the taxonomy and what proportion of the investment relates to enabling or transition activities (Art. 5). By 1 June 2021, the European Supervisory Authorities (ESAs) must draft technical standards for how the various investment products and their issuers will disclose this information regarding investments with climate change mitigation and adaptation objectives. Technical standards for disclosure about the other environmental sustainability categories (see 3-6 above) must be drafted by 1 June 2022 (Art. 25). The EC will decide and adopt the final regulatory technical standards so they can be applied from 1 January 2022 and 1 January 2023 respectively.

- If a financial product is not sustainable, it must be accompanied (Art. 7) by the following statement: 'The investments underlying this financial product do not take into account the EU criteria for environmentally sustainable economic activities.'.

- By 30 December 2020, the European Supervisory Authorities (ESAs) must propose (Art. 25(1)) how information should be disclosed regarding the principle of 'do no significant harm' under SDFR. The EC has the power to adopt the proposal.

The taxonomy law (Art. 8) also introduced changes to the **Non-Financial Reporting Directive** (NFRD) in order to force all large financial and non-financial companies to be more transparent about the sustainability of their activities. All large companies subject to NFRD must report whether or not, how, and to what extent their activities align with the objectives and criteria of the taxonomy. Non-financial companies must also disclose what proportion of their turnover, total investments (CAPEX) and expenditures (OPEX) meet the criteria, even if none of it does. The EC will decide on delegated acts to implement this amendment to the NFRD by 1 June 2021.

What criticism is there about the taxonomy law?

There is a great deal of concern and criticism about the effectiveness, loopholes and limitations of the taxonomy framework law and its aims as stated by the EC. From the civil society perspective, this criticism includes the following issues:

- The taxonomy will apply only to those private investors and investment/financial products that **voluntarily** choose to use its criteria and requirements for the activities they finance. The lack of compulsory application has the potential to allow a continued high level of greenwashing. Moreover, the reporting obligations allow financial products and investors to indicate that only a share of the activities they invest in are in accordance with the taxonomy, which calls the 'green' effectiveness of the investment into question. This is a missed opportunity for the EU's aim to ensure that all 'green' investments are actively mobilising additional funding for activities with positive outcomes for the EU's Green Deal targets and environmental policies. By continuing to allow various 'green' investments with minimal positive environmental impacts, there is a risk that this green financial 'bubble' might burst in the future when its ineffectiveness becomes clear and investors could suddenly and massively sell off their green investments.

- The EC expects the high EU standards to attract 'green investors'. However, investment products that choose to apply the taxonomy criteria in part or in full will incur significant costs due to the required screening criteria and verification. The financial industry has complained that all of the requirements, as proposed by the TEG, are too burdensome and costly in comparison with non-sustainable products. Investment products that actually contribute to climate change or that finance environmentally harmful activities have no additional costs, and are thus less expensive. As a result, in conjunction with its voluntary nature, the taxonomy law might not promote the movement of large amounts of capital towards activities that actively reduce climate change and environmental degradation.

- The environmentally sustainable activities according to the Taxonomy Regulation currently cover only an estimated one to five per cent of all investment products on the market.

- Although the inclusion of both transition and enabling activities would allow more financing for a transition towards climate mitigation, the positive impacts might be less clear for investors.

- The **date** for the **full application** of all provisions for the first two categories of the taxonomy is 1 January 2022. This is the result of delaying tactics by some EU member states as well as corporate lobbying. The remaining four categories (3 to 6) will only be fully applied from 1 January 2023 (in the best-case scenario).

- The taxonomy does not apply to the credit provided by EU banks, and only large banks are required to report on the extent to which their activities are in line with the taxonomy. However, banks are important financiers of all economic activities in the EU.

- A proposal for a 'full taxonomy' of all activities, including a definition of what is *not* environmentally sustainable, was rejected. Such a 'brown taxonomy' would define activities that are harmful to the climate and the environment and which should be avoided. The taxonomy law's review clause (Art. 26.2.a) requires that the EC shall identify and propose for inclusion as a category of the taxonomy any activities that **'significantly harm environmental sustainability'** before 31 December 2021.

- The review clause (Art. 26.2.b) provides for extending the taxonomy's categories to **socially sustainable activities** as well as other sustainable activities. The EC must publish a report on the social objectives requirements for such taxonomies before 31 December 2021. This is not helpful for those investing to achieve UN Sustainable Development Goals or for investors who have SDFR disclosure requirements for whether and how they apply environmental as well as social and governance (ESG) risks and impact assessments. Given that social and environmental standards reinforce each other, there is also an urgency to establish an EU taxonomy that combines climate, environment, and social and human rights requirements. This is also the approach taken by the OECD Guidelines for Multinational Enterprises.

- Although standard labour rights and human rights procedures must always be implemented as minimum social safeguards (Art. 18), there are no explicit processes set out for how this should be done in practice by those carrying out the environmentally sustainable economic activity. Only the Platform on Sustainable Finance has a mandate to advise the EC on the minimum safeguard requirements; the TEG report hardly covered this topic. As a result, the Taxonomy Regulation neglects to take into account the fact that social abuses often accompany environmentally destructive activities, and vice versa.

- The composition of the Platform on Sustainable Finance, as defined by law, is very ambitious as are the advisory roles. It includes representatives from opposite sides of the climate debate: from CO_2 emitting companies and lobbyists opposed to climate action policies to academics and environmental NGOs. It remains to be seen whether this body and its working groups can effectively advise the EC. How will the strong representation of business sectors be able to influence the outputs as compared to academics and NGOs? The current inclusion of gas in the taxonomy by the TEG and the potential inclusion of nuclear energy due to lobbying pressure, including from some member states, indicate the potential pitfalls of both the Platform and the Member States Expert Group in their advisory roles.

- The success of the taxonomy depends on the reception of **better information from the companies** in which investors place their money via shares and bonds. To date, neither the NFRD nor accountancy laws have processes in place for the standardisation and verification of company reports regarding ESG issues. The new requirement in the Taxonomy Regulation that all companies subject to NFRD must report on whether or not they are aligned with the taxonomy is a first step in improving transparency (Art. 8). The planned legal review of the NFRD should however go much further. Note that research, data provision, rating and verification about the ESG risks and impact of companies are not yet being regulated.

Timeline of the Taxonomy Regulation

2018

May 2018 | EC legislative proposal to introduce a Taxonomy.

July 2018 | A Technical Expert Group (TEG) was installed to advise the EC on technical details of the taxonomy's climate change mitigation and climate change adaptation activities.

2019

2020

9 March 2020 | The TEG published its final advisory report and a technical annex with detailed definitions of climate change mitigation and climate change adaptation activities.

12 July 2020 | The Taxonomy Regulation officially entered into force as a framework law in the EU member states.

18 December 2020 (midnight Brussels time) | Deadline for the public EC consultation on the draft delegated act with definitions of climate change mitigating and climate change adaptation activities.

1 October 2020 | The Platform on Sustainable Finance was established.

By 31 December 2020 | The EC needs to decide on the delegated act with the final detailed definitions of climate change mitigation and adaptation activities.

20 November 2020 | The EC published the draft delegated act with detailed definitions of climate change mitigating and climate change adaptation activities, for a four week public consultation.

By 30 December 2020 | The European Supervisory Authorities (ESAs) must draft a proposal for the content and the disclosure of the principle of 'do no significant harm' under SDFR to support the social minimum safeguards. The EC has the power to adopt this proposal thereafter as a Regulatory Technical Standard.

By 31 December 2021 | The EC has to decide on a delegated act with detailed definitions on four categories of environmentally sustainable activities (sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control, protection and restoration of biodiversity and ecosystems) after consultation processes during 2021.

2021

By 31 December 2021 | The EC must publish a report on whether and how the Taxonomy Regulation can be extended to activities that significantly harm environmental sustainability, do not have a significant impact on environmental sustainability, have social objectives, or have other sustainability objectives. The specificities of disclosure requirements related to transitional and enabling activities also have to be reviewed in the report.

By 1 June 2021 | The ESAs must draft technical standards on how sustainable investment products and their issuers will disclose their alignment with the taxonomy's climate change mitigation and adaptation categories.
By 1 June 2021 | All companies subject to reporting requirements of the Non-Financial Reporting Directive (NFRD) must provide information about whether or not, and to what extent, their activities align with the taxonomy.

30 April 2021 | Deadline for the European Parliament and the EU Council of Finance Ministers to object against the EC's delegated act on definitions of climate change mitigating and climate adaptation activities. This deadline can be extended for 2 months.

2022

1 January 2022 | The official taxonomy definitions of climate mitigation and adaptation activities as stated in the delegated act enter into force.
1 January 2022 | Technical standards on how sustainable investment products and their issuers disclose their alignment with the taxonomy's climate change mitigation and adaptation categories apply under the SDFR after an EC decision.

By 1 June 2022 | The ESAs must draft technical standards on how sustainable investment products and their issuers will disclose their alignment with the taxonomy's categories regarding sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control, and protection and restoration of biodiversity and ecosystems.

By 12 July 2022 (and every three years thereafter) | The Taxonomy Regulation and screening criteria must be reviewed.
By 13 July 2022 | The EC has to assess the effectiveness the advisory procedures and bodies to develop the taxonomy's definitions.

1 January 2023 | The official taxonomy definitions of the four categories of environmentally sustainable activities (sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control, protection and restoration of biodiversity and ecosystems) as stated in the EC delegated act enter into force.
1 January 2023 | Technical standards on how sustainable investment products and their issuers disclose their alignment with the taxonomy's categories regarding sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control, Protection and restoration of biodiversity and ecosystems apply under the SDFR after an EC decision.

2023

Colophon

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