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PERSPECTIVE

EU taxonomy:

vice or virtue?

July 2019

In May 2018, the European Commission presented its legislative agenda on financing sustainable growth.[1] With the agenda, the Commission intends to regulate the market for sustainable finance. This market is growing fast. In 2018, the inflow of new money into funds flagged as 'socially conscious' by Morningstar grew much faster than the inflow in the total European fund market. Yet, an analysis by ACTIAM showed that only half of these funds can actually be classified as sustainable.[2] This shows the need for EU regulation - to prevent non-sustainable funds from being marketed as sustainable. But will the proposed regulation lead to a more sustainable financial system? Will it lift the entire financial market or will it only help those that already operate sustainably?

This article provides arguments as to why the legislative agenda may help investors and offers a number of potential improvements.

EU ACTION PLAN ON FINANCING SUSTAINABLE GROWTH

The EU legislative agenda comprises four proposals:[3]

- a unified classification system ('taxonomy') on what can be considered to be an environmentally sustainable economic activity;
- an update to the regulation on disclosures relating to sustainable investments and sustainability risks to amend Directive EU 2016/2341. It is specifically aimed at institutional investors and asset managers;
- a new category of benchmarks consisting of low-carbon and positive carbon impact benchmarks;
- an EU Green Bonds Standard.

These proposals will be integrated in existing directives such as MiFID II, UCITS, Solvency II and AIFM, and as such will have an impact on all investors. This article primarily focusses on the first proposal, the EU taxonomy.

The Commission's aim is to put Environmental, Social and Governance (ESG) considerations at the heart of the financial system. The EU Taxonomy helps financial market participants, insurance providers and investment advisors to integrate ESG considerations into their internal processes and inform their clients accordingly.

It basically provides investors with tools for monitoring which part of their activities can be classified as sustainable (for each asset class). It currently focuses on climate change mitigation and adaptation, but will provide more guidance for other European environmental objectives in the coming years: in particular those relating to the sustainable use and protection of water and marine resources, to the transition to a circular economy, to pollution prevention and control and to the protection of healthy ecosystems.

To understand whether economic activities of a company are taxonomy-eligible, investors have to ascertain that the activity: [4]

- contributes substantially to at least one of the European environmental objectives,
- does no significant harm to any of the other objectives,
- complies with minimum social safeguards, and
- complies with the technical screening criteria.

The "do no significant harm" (DNSH) principle is an important addition to the taxonomy. Minimum requirements and performance standards will be formulated to avoid progress made against one objective being at the expense of others. The third point is also an important aspect. It broadens the sustainability concept to include compliance with basic social norms. Thus far, the taxonomy only takes account of compliance with employment policies and governance as set out in the ILO declaration on Fundamental Rights and Principles at Work.

For investors, the most relevant aspects of the taxonomy are the technical screening criteria. They define the conditions on which investments qualify as sustainable. The latest technical report on the EU taxonomy contains technical screening criteria for 67 activities that contribute to climate change adaptation and mitigation, including activities such as livestock production, manufacture of iron, production of electricity from hydropower and public transport.[4] These criteria describe, for each activity, aspects such as the maximum emissions per unit, the minimum emission reduction, the restrictions to land use, the required legislation, and the requirements for safeguarding DNSH. The criteria are set up in such a way that they can evolve and be honed over time to enable the transition to a low-carbon economy. They provide clarity to the market, but they also mean that investors will have to search for new ways to collect and process the data needed for their screening.

[1] https://ec.europa.eu/info/publications/180131-sustainable-finance-report_nl.

[2] https://www.actiam.com/49411b/siteassets/4_verantwoord/documenten/en/actiam_perspective_sustainable-funds.pdf.

[3] https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_nl#implementing.

[4] https://ec.europa.eu/info/files/190618-sustainable-finance-teg-report-taxonomy_en.

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HOW WILL THE EU TAXONOMY HELP ASSET OWNERS TO DEVELOP SUSTAINABILITY POLICIES?

At ACTIAM, we see the taxonomy as a major, positive step towards realising a sustainable future. In general, the taxonomy has received positive comments from other European investors as well. The most evident positive impact is that it provides clarity; clarity for newcomers in the sustainable financing arena, for data providers, for companies and for investors. The requirements identified enable new entrants to know the extent to which their investments are indeed sustainable, they enable data providers to align their data systems to the technical screening criteria and they enable companies to disclose the information required by the taxonomy. The regulation will create a level playing field by requiring substantiated disclosure by financial institutions. This will help clients to differentiate between truly sustainable investment institutions and those only pretending to be. This may counteract greenwashing and, so to speak, sort the wheat from the chaff. The EU expects this to lead to increased confidence in sustainable investments and, thus, initiate a reorientation of capital flows towards sustainable investments. Whether the taxonomy will actually have this impact remains to be seen.

Another positive aspect is that the taxonomy broadens the scope of sustainable investments. Many investors currently focus on climate and on reducing the carbon intensity of their portfolios. Notwithstanding the importance of the transition towards a low-carbon economy, the other European environmental objectives, such as those on biodiversity, water, circularity and waste prevention, are equally important for solving the challenges society currently faces. Several newly emerging sustainable funds in Europe already have a broader focus, e.g. on the planetary boundaries or the Sustainable Development Goals. By bringing these additional objectives to the attention of more investors, it may be that more, new investment solutions emerge that tackle multiple challenges.

HOW COULD THE TAXONOMY FURTHER HELP SUSTAINABLE INVESTORS?

Without a doubt, the new taxonomy pushes the bottom of the sustainable investment market upwards. However, does it also create new incentives for those already operating sustainably to do even better? The taxonomy would help to further advance the market for sustainable investments, if it would make a better distinction between the different shades of green. During the negotiations that led to the regulation, the plan to define 'non-sustainable' investments too (naming and shaming) was not adopted. As a result, the taxonomy enables the calculation of the percentage of a company's revenues that is taxonomy-eligible. However, it does not offer a correction for the possible negative impacts of the company's other activities on the EU environmental objectives. The DNSH principle only applies at activity level and not at company level.

That this leads to a lack of clarity becomes evident when we take a closer look at the new "positive impact strategies" that are gaining momentum. More and more sustainable funds claim that they contribute to the UN's Sustainable Development Goals. But a closer look at these funds quickly leads to the conclusion that there is no consensus on what it means to contribute to an SDG. Not all of these funds adopt the principle of 'do no significant harm' to other objectives. Some SDG impact strategies focus on a limited number of SDGs or on the extent of 'green revenues', not considering possible trade-offs or negative green revenues due to the other activities of the same company. The taxonomy would help sustainable investors more if it focused DNSH at company level rather than at activity level. One example of a fund that does consider such trade-offs is the ACTIAM Global Equity Impact Fund. It only invests in companies that make deliberate positive contributions to the SDGs while not harming any of the other sustainability principles. Companies making a positive contribution to one SDG while negatively contributing to another are not allowed in the fund. The taxonomy would help this part of the sustainable investment market by also formulating requirements for dark green investment solutions.

The more fundamental question is whether investors will indeed place sustainability at the heart of their financial decision-making process due to the taxonomy. After all, this is the Commission's ambition. Does the taxonomy sufficiently emphasise that investing in sustainable companies not only contributes to a sustainable society but will also be absolutely necessary for investors to maintain revenues in the long term? Climate change, water scarcity, pollution, declining biodiversity, as well as social unrest as a result of breaches of human or employment rights pose actual, existential risks. These are not only risks to society but also, in the medium to long term, to businesses, and therefore to investors. Companies that are insufficiently prepared for -for example- the water scarcity risk, are losing value already. Insufficient attention on the materiality of sustainability may result in asset dumping, instead of tackling the problem at its source and making the companies healthy again.[5]

In its sustainability policy, ACTIAM measures whether companies have sufficient adaptive capacity to tackle the risks that the transition to sustainability are likely to bring about. It follows the taxonomy by measuring the impact of companies' behaviour on sustainability, but also goes one step further. Companies are categorised as sustainable only if they have the adaptive capacity to adopt the innovations needed, for example, for a transition to a low-carbon society. It would help the market if the taxonomy would also adopt a more forward-looking stance and consider, as well, the materiality of making these transitions. Many investors may be more sensitive to arguments of financial materiality than to arguments about the impact to society. Investors would benefit if the technical screening criteria contained indicators for the material risks of not being sufficiently prepared for the transition to sustainability. This would place sustainability even more at the heart of financial decision-making.

[5] Financieel Dagblad (2019). Speculeren op een veranderend klimaat. June 1st 2016 [in Dutch].

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CONCLUSION

Notwithstanding the improvement mentioned above, the EU legislative agenda on financing sustainable growth and the taxonomy in particular, constitute a major, positive step towards realising a sustainable future. One of the major obstacles for new investors entering the market for sustainable investments, namely the lack of standardisation, is finally being addressed. The legislation also stimulates frontrunners in sustainable investment, i.e. those that already have solid sustainability policies, to further strengthen their strategies. The clarity and level playing field which the taxonomy will create will make the market for sustainable investments more transparent, more reliable and more robust.

This is a publication of ACTIAM's Sustainability & Strategy team, consisting of 9 professionals with an average of 11 years in the industry.

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