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The European Taxonomy: the foundation of the European regulatory strategy for sustainable finance

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On July 6 2021, the European Commission published several documents that are part of a series of measures aimed at redirecting European financial flows towards more "sustainable" activities. These include the Commission's new strategy for « financing the transition to a sustainable economy»[1], a proposal for the new EU Green Bond Standard[2], and the adoption of the Delegated Act supplementing Article 8 of the Taxonomy Regulation[3].

On April 21 2021, more specifically, the European Commission adopted a series of measures including delegated acts relating to the climate change component of the **European Taxonomy**[4;5] and a proposal to revise the Corporate Sustainability Reporting Directive (CSRD), which will replace the Non-Financial Reporting Directive (NFRD)[6] and will be necessary for the implementation of the European Taxonomy.

The European Taxonomy is therefore at the heart of the EU's strategy for sustainable finance: it is a complex and ambitious regulatory project with a wide range of implementation mechanisms.

In this article, we retrace its genesis and answer some fundamental questions. What are the objectives of this European Taxonomy? How does it work? Which actors will be concerned by its application and what will be its uses? How will it evolve?

The genesis of the Taxonomy and its objectives

The economic and demographic development of human societies has led to an increase in energy and material flows. This has resulted in numerous environmental impacts, including climate change, loss of biodiversity, air, water and soil pollution and the scarcity of several natural resources. Human societies have entered into a crisis of sustainability.

The European Union has adopted a plan to reduce its greenhouse gas emissions, which should lead to "carbon neutrality" by 2050, with an intermediate milestone of -55% of its emission in 2030 compared to 1990 levels. In the impact assessment of its climate plan[7], the annual investment required to achieve this objective is €350 billion. This amount is recalled in the "Strategy for financing the transition to a sustainable economy", alongside the €130 billion annual investment needed to meet its other environmental objectives. Public investment may not be sufficient to channel such sums, and it is therefore necessary to **redirect** private financial flows into activities compatible with the general direction taken.

On March 8 2018, the European Commission communicated its "Action Plan: Financing Sustainable Growth"[8]. **The first element of this action plan is the creation of a European Taxonomy.**

The European Commission therefore commissioned a 35-member Technical Expert Group (TEG) for Sustainable Finance to develop a first version of the Taxonomy focusing on climate change mitigation and adaptation objectives. The group delivered its **final report**[9] in March 2020. The report contains recommendations on the overall design of the EU Taxonomy, as well as guidance on how companies and financial institutions can (and should) publish information using the Taxonomy. It contains a proposal for the economic activities covered and technical criteria for assessing the sustainability of an activity.

Jean-Yves Wilmotte, Manager Head of Carbone 4's finance branch

Carbone 4 was represented within the TEG (Technical Expert Group) by Jean-Yves Wilmotte, manager head of Carbone 4's finance branch. The TEG's mandate was to help the European Commission develop:

- A classification system - the European Taxonomy - to determine whether an activity could be considered environmentally "sustainable";
- The development of a green bond standard (EU Green Bond Standard);
- The development of market indices in line with the Paris agreement;
- A corporate reporting, which should provide the transparency necessary for the implementation of all other financial sector initiatives.

More specifically, Jean-Yves Wilmotte worked on the third point, the Climate Transition Benchmarks (CTB) and Paris-Aligned Benchmarks (PAB).

The Taxonomy Regulation **(EU) 2020/852**[10] was published in the Official Journal of the European Union in June 2020. This regulation, unlike a directive, applies directly to any European actor, without the need for transposition into Member State law.

In October 2020, the European Platform on Sustainable Finance was set up and took over from the TEG in the development of the Taxonomy; its role includes helping to define the technical criteria that will ultimately be used, as well as the ongoing review of the Taxonomy Regulation. The Platform published its first report[11] in March 2021.

How does the Taxonomy work?

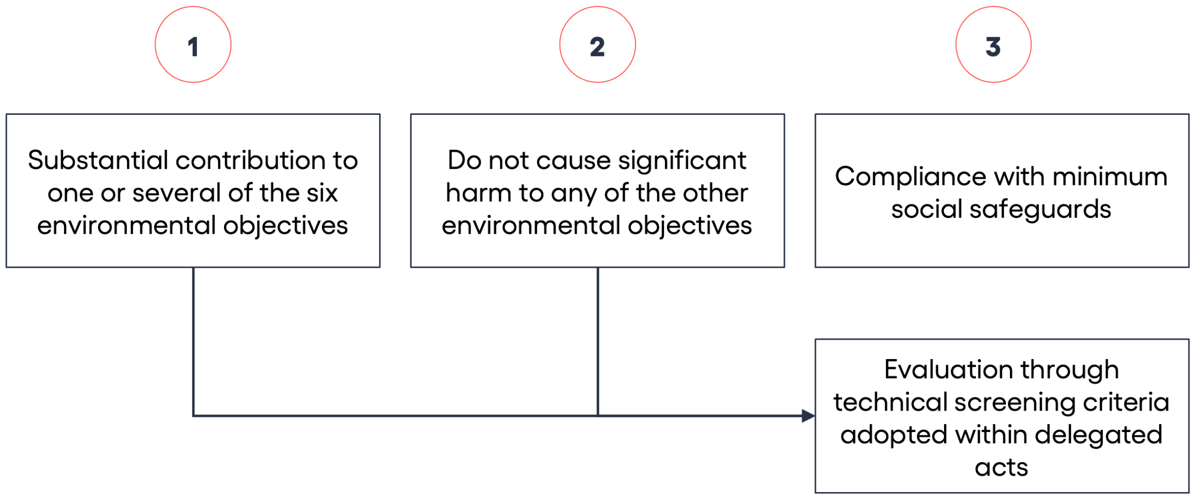
The objective of the European Taxonomy is to create a classification system for what is considered "sustainable" from an environmental and social point of view. It creates a framework and principles for assessing economic activities against six environmental objectives.

Climate change mitigation	Climate change adaptation
Sustainable use and protection of water and marine resources	Transition to a circular economy
Pollution prevention and control	Protection and restauration of biodiversity and ecosystems

The six environmental objectives

It sets out technical screening criteria for each economic activity covered by the taxonomy to determine whether it can be considered “sustainable”. It should be not actions: in other words, an activity is considered "sustainable" as such, regardless of whether it replaces or is in addition to another less "sustainable" activity.

The way it works is that an activity can be considered "sustainable" if it contributes substantially to one of the six environmental objectives, without causing significant harm (DNSH for Do No Significant Harm) to any of the other five objectives. An activity must also meet basic social criteria (or Minimum Social Safeguards) to be considered "sustainable" (aligned with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights).



Procedure for assessing the sustainability of an activity

The European Taxonomy is probably the most complex financial reorientation project ever created. It requires the identification and assessment of all activities within an economy and whether that activity can be considered “sustainable”. In the version of the mitigation delegated act adopted on April 21 of 2021, **technical screening criteria are specified for 88 activities.**

Activities using natural gas and nuclear energy as energy vectors are the subject of intense discussions, which are not yet conclusive and are not included in the first delegated acts. These activities will be the subject of a specific delegated act.

In addition, the Taxonomy differentiates between several "shades of green" when assessing the substantial contribution to mitigation when assessing the substantial contribution to mitigation: “sustainable”, “transitional” and “enabling”:

As we have seen, "**sustainable**" activities contribute substantially to one of the six environmental objectives, without causing significant harm to any of the other five objectives, while meeting basic social criteria.

Thus, the generation of electricity by a hydroelectric plant can be considered a "**sustainable**" activity if it meets one of the following substantial contribution criteria:

(a) the power generation facility is a run-of-river plant and does not have an artificial reservoir;

(b) the power density of the electricity generating facility is greater than 5 W/m2;

(c) the lifecycle GHG emissions of electricity generation by a hydropower plant are less than 100g CO2 equivalent/kWh.

The hydropower generation activity must also not cause significant harm to any of the other five objectives, while meeting basic social criteria to be considered "**sustainable**".

The threshold of 100gCO2e/kWh is generally found in other modes of electricity generation and transmission.

The activity of collecting and transporting non-hazardous waste can be considered a "**sustainable**" activity if it meets the following substantial contribution criteria:

(a) The waste must be sourced, separated and collected separately;

(b) the waste must be destined for re-use or recycling operations.

The activity of collecting and transporting non-hazardous waste must also not cause significant harm to any of the other five objectives, while meeting the basic social criteria to be considered "**sustainable**".

"**Transitional**" activities are those activities for which there is no economically or technologically viable low-carbon alternative, and can be considered to make a substantial contribution to climate change mitigation when these activities:

"(a) have greenhouse gas emission levels that are in line with the best performance of the sector or industry;

b) do not impede the development and deployment of low-carbon alternatives;

(c) do not result in a lock-in of carbon-intensive assets, considering the economic lifetime of those assets."

Thus, the passenger interurban rail transport activity can be considered "**sustainable**" if:

(a) Its direct (exhaust) CO_2 emissions are zero; [i.e., 100% electric or hydrogen powered trains].

It is considered "**transitional**" if:

(b) Its direct CO_2 exhaust emissions are zero when on a track equipped with the necessary infrastructure, and a conventional engine is used when such infrastructure is not available (bimodal); [i.e., electric trains when the line has catenaries and diesel otherwise].

The passenger interurban rail transport activity must also not cause significant harm to any of the other five objectives, while meeting the basic social criteria to be considered "**transitional**" or "**sustainable**" (depending on the substantial contribution criterion).

The primary aluminium production activity can also be a "**transitional**" activity if it meets two of the following three substantial contribution criteria until 2025 and all the following substantial contribution criteria after 2025:

(a) greenhouse gas emissions (within the scope of the EU-ETS) do not exceed 1.484tCO_2 per ton of unalloyed liquid aluminium, which is the average value for the most efficient 10% of installations;

(b) the carbon intensity of indirect electricity-related emissions (scope 2) does not exceed the threshold of 100gCO_2e/kWh;

(c) the electricity consumption for the manufacturing process does not exceed 15.5MWh per ton of aluminium.

The secondary aluminium production activity (for recycled aluminium) can be directly considered as "**transitional**": the fact that the aluminium produced is secondary exempts the activity from the substantial contribution criterion.

The primary or secondary aluminium production activity must also not cause significant harm to any of the other five objectives, while meeting the basic social criteria to be considered "transitional".

There are 21 "transitional" activities.

"**Enabling**" activities are those activities that enable activities other than objectives, and can be considered to contribute substantially to one of the six environmental objectives provided that these activities:

(a) do not result in a lock-in of assets that compromise long-term environmental objectives, considering the economic lifetime of those assets; and

b) have a significant positive environmental impact based on life-cycle considerations.

For example, the construction of infrastructure for personal mobility is an "**enabling**" activity if it is intended for active mobility (walking, cycling, etc.), or for electric charging or hydrogen refueling.

There are 24 "enabling" activities.

It is worth noting that both "**transitional**" and "**enabling**" activities can make a substantial contribution to one of the environmental objectives and as such can be qualified as "**sustainable**". Ultimately, the qualification of "**sustainable**" is the main objective of the taxonomy. The qualification of "**transitional**" and "**enabling**" activities as "**sustainable**" will simply be mentioned in the reporting of these activities.

Broad application modalities

The Taxonomy Regulation will be applied across a number of measures and initiatives, which we will discuss in this section. A distinction should be made between mandatory implementation, which the concerned actors will have to comply with, and voluntary implementation, which will not be imposed but which will play a role in structuring the market for “sustainable” finance.

Mandatory uses:

Reporting under Article 8 of the Taxonomy Regulation

The companies subject to the non-financial reporting requirements under the Non-Financial Reporting Directive (NFRD, replaced by the CSRD, see note 6), which include public interest entities (see Box) with more than 500 employees are also subject to the reporting requirements under Article 8 of the Taxonomy Regulation.

The companies covered (see Box) will have to publish the following information:

- The share of their **turnover** derived from products or services associated with economic activities that can be considered "sustainable" (a distinction is made for "transitional" and "enabling" activities).
- The share of their **capital expenditure** (CapEx) and the share of their **operating expenditure** (OpEx) related to assets or processes associated with economic activities that can be considered "sustainable" (a distinction is made for "transitional" and "enabling" activities).

A proposal for a revision of the Non-Financial Reporting Directive (NFRD), to be called the Corporate Sustainability Reporting Directive (CSRD), has been published together with the delegated acts for mitigation and adaptation. It proposes to extend the scope of these obligations to all **public interest entities** and without the application of the 500-employee threshold or admission to trading on a regulated market that prevailed in the NFRD; as well as to listed SMEs (apart from micro enterprises). This would increase **the number of companies covered from 11,000 to around 50,000.** However, lighter requirements would apply to smaller companies.

Public interest entities are credit institutions, insurance and reinsurance undertakings, provident institutions, mutual societies, companies whose securities are admitted to trading on a regulated market, certain companies with a consolidated or combined balance sheet of more than EUR 5 billion.

Financial companies will also have to publish these elements applied to their assets under management (asset management companies), balance sheet (credit institutions), or underwriting activities (insurance companies).

The delegated act relating to the precise modalities of the application of Article 8 of the Taxonomy Regulation is part of the documents published on July 6 2021.

This reporting obligation will apply from **January 2022** based on the 2021 financial year for the first two environmental objectives (mitigation and adaptation), then from January 2023 based on the 2022 financial year for the other four environmental objectives. In this first phase, only the reporting the eligibility of the activities is covered.

In a second phase, key performance indicators (KPIs) accompanying and specifying these reporting obligations will have to be published by companies (**January 2023** based on the 2022 financial year) and financial institutions (January 2024 based on the 2023 financial year). This second phase will

Reporting under articles 5 to 7 of the Taxonomy Regulation

The Taxonomy Regulation refers in its articles 5 to 7 to the Sustainable Finance Disclosure Regulation (SFDR)[12].

The financial products covered by the SFDR will have to publish appropriate reporting, described below.

The financial products within the SFDR are classified as follows:

Article 9 products (number of the article within the SFDR that characterizes them), the most ambitious and have a sustainable investment objective.

Article 8 products are those that include social or environmental characteristics.

The other products, known as **Article 6 products**, are financial products that do not have a sustainable investment objective nor integrate environmental or social characteristics.

The Taxonomy Regulation therefore states that financial products with a sustainable investment objective (**Article 9** within the SFDR) and products integrating environmental or social characteristics (**Article 8** within the SFDR), will be subject to the following information disclosure:

- Information on the contribution of the investments underlying the financial product to one or more of the six environmental objectives;
- A description of how and to what extent the investments underlying the financial product are made in economic activities that can be considered "**sustainable**", i.e., the share of the portfolio aligned with the Taxonomy.

The Taxonomy Regulation also requires that financial products that do not have a sustainable investment objective or integration of environmental or social characteristics (**Article 6** within the SFDR) be specifically declared as such.

Voluntary uses:

Beyond the mandatory reporting requirements, the Taxonomy Regulation will also be used voluntarily by the market in the development of investment solutions. The second element of the "Action Plan: Financing Sustainable Growth" is to **create standards and labels for “green” financial products**. For example, the Green Bond Standard and the possibility to use the EU Ecolabel framework for several retail financial products are among the voluntary uses of the European Taxonomy.

The EU Green Bond Standard

The green bonds market has developed strongly in recent years. These bonds require a definition of what can be considered green. However, the definitions that this market has relied on (e.g., the Green Bond Principles) are far less comprehensive and ambitious than the European Taxonomy. The Expert Group (TEG) therefore recommended in June 2019[13] and again in March 2020[14] the use of the European Taxonomy in the context of green bond issuance.

This includes increasing transparency towards stakeholders and in particular financial actors investing in green bonds by providing guidelines on:

- Eligible activities
- Principles to be respected
- Indicators to be monitored
- Reporting
- Compliance with the DNSH (Do No Significant Harm, i.e., do not cause significant harm to any of the other environmental objectives)
- The environmental objectives pursued by the green bond in the sense of the Taxonomy

Based on an impact assessment and a public consultation[15], which were held in 2020, the European Commission has therefore made its proposal for its new standard for European green bonds.

The standard will be open to European and non-European issuers, be they companies, governments, or financial institutions. The standard requires that **100% of the funds raised comply with the requirements of the European Taxonomy** to call the corresponding bond a "European Green Bond". It is therefore a strong and structuring element towards a standardization of the green bond market based on the European Taxonomy.

Ecolabel

The use of labels can improve the readability of several financial products, especially for retail investors.

Among the labels currently used to promote financial products (such as investment funds), we find

- In France: the SRI label & the GreenFin label.
- In Europe: LuxFlag Climate Finance and LuxFlag Environnement, Nordic Swan Ecolabel & Towards Sustainability.

The Ecolabel project would consist in labelling funds whose underlying investments contribute to the environmental objectives specified in the European Taxonomy. A "Taxonomy score", or alignment with the Taxonomy, would be turnover or capital expenditures can be considered "**sustainable**" according to the Taxonomy. This label therefore would have the potential to allow a fund to display in a readable way its contribution to "**sustainability**" as defined by the Taxonomy Regulation.

The current proposals of this Ecolabel can be consulted in its 4th technical report[16].

The final publication of the Ecolabel for retail financial products is planned for **the end of 2021**.

A clear strengthening of sustainability reporting requirements for companies and financial institutions should lead to a greater availability of data related to the sustainability of corporate activity. This new data could allow for the development of these voluntary uses, which have the potential to structure the financial products market largely around the European Taxonomy.

The European Taxonomy is being finalized: the delegated acts on climate change mitigation and adaptation, as well as the delegated act specifying the mandatory implementing rules, are already published. The EU Green Bond Standards and the Ecolabel project are expected to be in place by the end of 2021. The delegated acts for the other four environmental objectives of the Taxonomy Regulation are expected to be published in 2022.

The technical review criteria for assessing the sustainability of activities will be reviewed every three years by the European Platform on Sustainable Finance (the first review is to be held in July 2022).

The Taxonomy will play a central role in the EU's sustainable finance strategy. It will be used as a reference by other initiatives, such as the Benchmark[17] Regulation (certain components of indexes will be excluded if they are detrimental to any of the environmental objectives), the European investment program InvestEU[18] (which will progressively incorporate requirements linked to the Taxonomy), as well as fiduciary, investment advisory and insurance obligations[19].

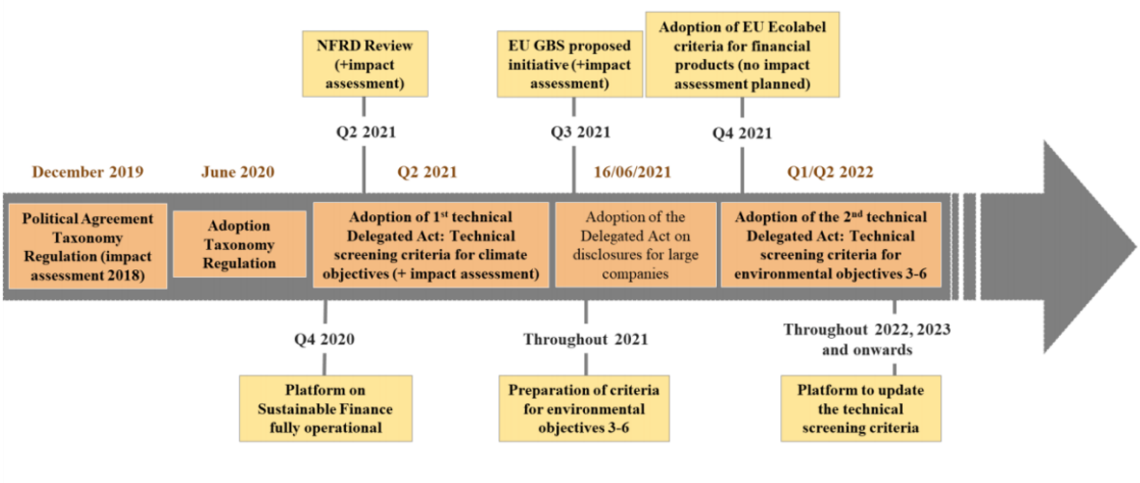


Figure 2: Timeline of files related to the Taxonomy Regulation

https://ec.europa.eu/finance/docs/level-2-measures/taxonomy-regulation-delegated-act-2021-2800-impact-assessment_en.pdf

Towards a Brown Taxonomy?

The transformation of the economy that is essential in the light of climate change requires the reorientation of financing and investments towards more sustainable activities. It also requires a large-scale divestment in the least sustainable activities, based on the use of fossil fuels, which are responsible for the sustainability crisis we are experiencing, and which must be stopped as a matter of urgency. The Taxonomy Regulation thus contains a clause assigning the European Commission to conduct in a study on to what extent the European Taxonomy could be extended to a Taxonomy classifying also the most harmful activities (a "brown" Taxonomy), as well as activities with a low environmental impact.

[1] https://eur-lex.europa.eu/resource.html?uri=cellar:9f5e7e95-df06-11eb-895a-01aa75ed71a1.0001.02/DOC_1&format=PDF

[2] https://eur-lex.europa.eu/resource.html?uri=cellar:e77212e8-df07-11eb-895a-01aa75ed71a1.0001.02/DOC_1&format=PDF

[3] https://ec.europa.eu/finance/docs/level-2-measures/taxonomy-regulation-delegated-act-2021-4987_en.pdf

[4] https://eur-lex.europa.eu/resource.html?uri=cellar:d84ec73c-c773-11eb-a925-01aa75ed71a1.0021.02/DOC_2&format=PDF

[5] https://eur-lex.europa.eu/resource.html?uri=cellar:d84ec73c-c773-11eb-a925-01aa75ed71a1.0021.02/DOC_3&format=PDF

[6] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52021PC0189&from=EN

[7] https://eur-lex.europa.eu/resource.html?uri=cellar:749e04bb-f8c5-11ea-991b-01aa75ed71a1.0001.02/DOC_1&format=PDF

[8] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018DC0097&from=FR

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

[10] https://eur-lex.europa.eu/legal-content/FR/TXT/PDF/?uri=CELEX:32020R0852&from=F

[11] https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/210319-eu-platform-transition-finance-report_en.pdf

[12] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R2088&from=EN

[13] https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/190618-sustainable-

[14] https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/200309-sustainable-finance-teg-green-bond-standard-usability-guide_en.pdf

[15] https://ec.europa.eu/info/consultations/finance-2020-eu-green-bond-standard_en

[16] https://susproc.jrc.ec.europa.eu/product-bureau//sites/default/files/2021-03/2021.03.05%20-%20EUEL%20financial%20products%20-%20Technical%20Report%204%20FINAL.pdf

[17] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R1011&from=FR

[18] https://europa.eu/investeu/contribution-green-deal-and-just-transition-scheme_en

[19] The Commission adopted six amending delegated acts on fiduciary duties, investment advice and insurance to ensure that financial firms, e.g. advisors, asset managers or insurers, integrate sustainability into their procedures and investment advice to clients: https://ec.europa.eu/info/publications/210421-sustainable-finance-communication_fr

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