GREEN TAXONOMY

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KEY ISSUES

Objective of the Regulation: The Regulation sets out the criteria that economic activities must comply with to qualify as "environmentally sustainable".

Affected parties: Financial market participants, especially retail and institutional investors, all enterprises.

Pro: An EU green taxonomy may help meet the increasing demand by institutional as well as retail investors for "sustainable" financial products.

Contra: (1) The existence of different taxonomies and labels is not a sign for a market failure but rather reflects the fact that there is not and cannot be an objective or common understanding of "sustainability". There is hence no need for public action by the EU to develop a public EU green taxonomy.

(2) The EU green taxonomy drives private taxonomies out of the market. If the EU were to develop an own taxonomy, its use should be optional, not mandatory.

(3) Any direct reference in financial market regulation for banks, insurance or investment firms to the green taxonomy should take place with caution, as sustainable investments may carry a high risk. First and foremost, financial market regulation should ensure financial stability.

Alternative Approach: If the EU were to develop an own taxonomy, its use should be optional, not mandatory.

The most important passages in the text are indicated by a line in the margin.

CONTENT

Title

Proposal COM(2018) 353 of 24 May 2018 for a **Regulation on the establishment of a framework to facilitate sustainable investment**

Brief Summary

► **Objectives and scope**
- The Regulation sets out four cumulative criteria that economic activities – and hence also investments in these activities – must comply with to qualify as "environmentally sustainable" [Art. 1 (1)]. It thus establishes an EU-wide green taxonomy for investments.
- Any EU or national measure applying to "environmentally sustainable" financial activities must rely on this taxonomy [Art. 1 (2), Art. 4 (1)].
- All "financial market participants" claiming that their "financial products" are "environmentally sustainable" or have "similar characteristics" must disclose information as to "how and to what extent" the criteria of this Regulation are used to determine the environmental sustainability of the investment [Art. 1 (2), Art. 4 (2)].

► **Definitions**
- "Financial markets participants" are [Art. 2 (1) (b)]
  - managers of alternative investment funds (AIF), undertakings for collective investment in transferable securities (UCITS), venture capital funds (EuVECA) and social entrepreneurship funds (EuSEF),
  - insurance companies that offer insurance-based investment products (IBIPs), i.e. products which offer a maturity or surrender value which is exposed to market fluctuations,
  - investment firms that provide portfolio management,
  - institutions for occupational retirement provision (IORPs), i.e. institutions which provide retirement benefits based on agreements between employers and employees, and
  - providers of "pension products".
- "Financial product" means a portfolio management, an AIF, an IBIP, a pension product, a pension scheme or a UCITS [Art. 2 (1) (c)].

► **The four cumulative criteria for an EU-wide green taxonomy**

"Environmentally sustainable" activities must [Art. 3]:
- (1) contribute "substantially" to one or more of the six environmental objectives of the Regulation,
- (2) not substantially harm any of such environmental objectives,
- (3) meet the "technical screening criteria" that define for each environmental objective what "substantial" contribution and "substantial" harm means ("substantiality test") [Art. 6–11], and
- (4) comply with "minimum safeguards".

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- **Criterion 1: Substantial contribution to one or more of the six environmental objectives**
  Activities will only be "environmentally sustainable" if they contribute substantially to one or more of the following six objectives:
  – (1) Climate change mitigation*:* As from July 2020, they eliminate or reduce greenhouse gas concentrations or enhance their removal. Generating or using renewable energy, investing in power grid reinforcement and "increasing clean mobility" are mentioned as possible means to achieve this [Art. 6 (1), Art. 18 (2)];
  – (2) Climate change adaptation: As from July 2020, they reduce the "negative effects" of current or future climate and prevent an increase or shift of negative climate change effects [Art. 7 (1), Art. 18 (2)];
  – (3) Sustainable use and protection of water and marine resources: As from 2022, they preserve "the good status" of waters, e.g. by ensuring adequate collection and treatment of urban and industrial waste waters and improving water efficiency [Art. 8 (1), Art. 18 (2)];
  – (4) Transition to a circular economy, waste prevention and recycling: As from 2021, they must improve the efficient use of raw materials in production and increase the recyclability of products [Art. 9 (1), Art. 18 (2)];
  – (5) Pollution prevention and control: As from 2021, they ensure a high level of environmental protection from pollution, e.g. by reducing air, water and soil pollutant emissions other than greenhouse gasses as well as minimising significant adverse effects of the production and use of chemicals on human health and the environment [Art. 10 (1), Art. 18 (2)];
  – (6) Protection of healthy ecosystems: As from 2022, they protect, conserve and enhance biodiversity and ecosystem services in line with the relevant legislative and non-legislative EU instruments, e.g. by nature conservation and sustainable land management [Art. 11 (1), Art. 18 (2)].

- **Criterion 2: No significant harm to the six environmental objectives**
  Environmentally sustainable activities must not "significantly harm" any of the six environmental objectives listed above [Art. 12].

- **Criterion 3: Technical screening criteria ("substantiality test")**
  – The Commission sets out in detail in delegated acts the technical screening criteria that must be met in order to qualify the contribution to or harm of environmental objectives as "substantial" [Art. 6 (2)–11 (2)].
  – The technical screening criteria shall, inter alia, [Art. 14]
    - identify the most relevant potential contributions to the environmental objective under consideration, focussing on the longer term impacts of a specific economic activity;
    - build upon EU labelling, certification and statistical classification systems;
    - be based on conclusive scientific evidence and comply with the precautionary principle as set forth by article 191 TFEU, meaning that in case of non-conclusive scientific evidence, that activity shall be qualified as harmful for the environment;
    - take into account the nature and the scale of the economic activity;
    - take into account the potential impact on liquidity in the market, the risk of certain assets becoming stranded as a result of losing value due to the transition to a more sustainable economy, as well as the risk of creating inconsistent incentives;
    - ensure that activities carried out in the same sector, which contribute equally to one or more environmental objective, are treated equally and an easy compliance review.

- **Criterion 4: Compliance with "minimum safeguards"**
  – Environmentally sustainable activities must observe the principles and rights of "the eight fundamental conventions" of the "International Labour Organisation declaration on Fundamental Rights and Principles at Work" [Art. 13].
  – These are (1) the right not to be subjected to forced labour, (2) the freedom of association, (3) workers' right to organise, (4) the right to collective bargaining, (5) equal remuneration for men and women workers for work of equal value, (6) non-discrimination in opportunity and treatment with respect to employment and occupation, as well as (7) the right not to be subjected to child labour. [Art. 13]

Statement on Subsidiarity by the Commission

In the absence of an EU taxonomy, the EU's environmental and climate policy goals would induce Member States to introduce national taxonomies [p. 4 Explanatory Memorandum]. These are unfit to address the problem and likely to prejudice the functioning of the internal market [pp. 32–33 Impact Assessment].

Policy Context

This proposal is part of the Commission's "Action Plan on Financing Sustainable Growth" [COM(2018) 97, cf. cep**PolicyBrief**]. It is meant to enable the EU to reach the goals set by the 2016 Paris Agreement on climate change and the United Nations 2030 Agenda for Sustainable Development by implementing the recommendations of the High-Level Expert Group on Sustainable Finance (HLEG).

Legislative Procedure

24.05.2018 Adoption by the Commission
Open Adoption by the European Parliament and the Council, publication in the Official Journal of the European Union, entry into force

Options for Influencing the Political Process

Directorates General:	Directorate-General for Financial Stability, Financial Services and Capital Markets Union (DG FISMA)
Committees of the European Parliament:	Economic and Monetary Affairs (leading), Rapporteur: Sirpa Pietikäinen (EPP, FI)
Federal Germany Ministries:	Finance (leading)
Committees of the German Bundestag:	Finance (leading)
Decision-making mode in the Council:	Qualified majority (acceptance by 55% of Member States which make up 65% of the EU population)

Formalities

Competence:	Art. 114 TFEU (Internal Market)
Type of legislative competence:	Shared competence (Art. 4 (2) TFEU)
Procedure:	Art. 294 TFEU (ordinary legislative procedure)

ASSESSMENT

Economic Assessment

With the EU green taxonomy, the Commission aims at bindingly defining what "environmentally sustainable" means. This raises a number of questions.

First: There are already a number of public and private taxonomies and labels defining sustainability. The Commission's argument, that this diversity hinders the development of a European market for sustainable finance products, is not convincing. Surely, sustainability labels footing on **an EU green taxonomy may help meet the increasing demand by institutional as well as retail investors for "sustainable" financial products** and investments. **However, the existence of different taxonomies and labels is not a sign for a market failure but rather reflects the fact that there is not and cannot be an objective or common understanding of "sustainability".** It is perfectly legitimate to classify sustainable activities by using different criteria and weighing them differently in case of conflicts between different environmental objectives. **There is** hence **no need for public action – here by the EU – to develop a public EU green taxonomy.**

Second: There is no guarantee that **the EU green taxonomy** will better match investors' (diverging) understanding of "sustainability" than other private or public taxonomies do. Hence, it is all the more problematic that the EU is not willing to face competition with other taxonomies, but rather wants to monopolise the interpretation of the concept of "sustainability". It **drives private taxonomies out of the market**. This may avoid extreme cases of green-washing – i.e. misleading investors by falsely claiming an activity to be sustainable – but causes similar problems because of the diverging understanding of sustainability amongst investors. **If the EU were to develop an own taxonomy, its use should be optional, not mandatory.** However, even an optional EU green taxonomy would distort competition to the detriment of private taxonomy and label developers, given its very cost intensive development which is financed with public funds.

Third: The consequences for the economy and acceptance of the green taxonomy depend on unknown factors, as the Commission will set screening criteria for its substantiality test. However, judging the "sustainability" of each and every economic activity is a monumental task and it is difficult to image how such a complex task can lead to a binary decision on the (non)sustainability of an activity. Also, this approach may at best be suited for "green" project bonds, not for equity. An enterprise may engage in activities of different degrees of sustainability. Aggregating the different sustainability assessments of these activities into one single assessment seems quite arbitrary. This leaves room for industrial and political lobbying on the Commission's delegated acts at the detriment of the taxonomy's credibility.

Fourth: The EU taxonomy will at first only deal with climate change mitigation and adaptation. Other environmental factors as well as social and governance factors will only be considered later. This may be understandable from a practical point of view. However, given the proposed mandatory nature of the EU-taxonomy, this can distort competition between economic actors in an unfair way and mislead investors.

Fifth: Given complex supply chains and the use of intermediate products of different subcontractors, it may be difficult for enterprises to ensure that they meet the "minimum safeguards", e.g. on equal remuneration or non-discrimination.

Sixth: Although not explicitly mentioned in this proposal, it is not unlikely that the taxonomy definition of sustainability will find its way in the prudential regulation of financial actors such as banks or insurances. This will leverage the influence of the taxonomy and increase the likelihood of more financial means being directed into "sustainable" activities, which is the primary objective of the European sustainable finance agenda. **Any direct reference in financial market regulation for banks, insurance or investment firms to the green taxonomy should take place with caution**, **as sustainable investments may carry a high risk. First and foremost, financial market regulation must ensure financial stability.** Other policy goals – such as sustainability – must only be secondary. Also, an integration of the green taxonomy in financial market regulation can have significant impacts on the financing costs – and hence the profitability – of economic activities. Given that the EU green taxonomy is not "objectively correct", this would result in a questionable steering of industrial policy.

Legal Assessment

Legislative Competence of the EU

Unproblematic.

Subsidiarity

Unproblematic.

Proportionality with respect to Member States

Unproblematic.

Compatibility with EU Law in other Respects

The Regulation delegates important policy decisions to the Commission. This raises the problem of whether it breaches Art. 290 para. 1 TFEU, which reserves "the essential elements of an area" to the legislature and positively excludes that such elements can be the subject of a delegation of power.

According to the case law of the CJEU, elements shall be categorised as "essential" on a case-by-case basis, following an assessment based on objective factors, and amenable to judicial review (Parliament v Council, C‑355/10, para. 67; Czech Republic v Commission, C-696/15 P, para. 77). Notably, an element is essential if, in order to be adopted, it requires political choices falling within the responsibilities of the EU legislature, in that it requires the conflicting interests at issue to be weighed up on the basis of a number of assessments (Parliament v Council, C‑355/10, para. 65; DK Recycling und Roheisen / Commission, C-540/14 P, para. 47). In this context, due account must be taken of the characteristics and particular features of the field concerned (Parliament v Council, C‑355/10, para. 68; Czech Republic v Commission, C-696/15 P, para. 77).

The political nature of a choice does not, however, justify *per se* its reservation to the EU legislature: according to the CJEU, "even if a decision […] involves certain compromises with technical and political dimension, such a decision cannot be regarded as requiring political choices falling within the responsibilities of the EU legislature" [Parliament v Council, C-363/14, para. 51]. Accordingly, as it also follows from old case-law, only those provisions "which are intended to give concrete shape to the fundamental guidelines of [EU] policy" [C-240/90 Germany v Commission] are to qualify as "essential" under the Treaty.

As a consequence, setting the technical screening criteria cannot be regarded as an essential element of the Regulation. The latter contains two crucial policy decisions: the establishment of a green taxonomy for the purpose of identifying green investments; and the green objectives in respect to which this taxonomy is to be designed. Albeit the delegated acts establishing the criteria could lead to a re-orientation of investor preferences and are, consequently, susceptible to produce a great impact on several industrial sectors, their main aim is to set forth in the most appropriate way the details of the above framework. Also, this interpretation takes into due consideration the characteristics and particular features of evaluating environmental sustainability, which entails a high level of technically complex assessments and needs constant monitoring due to the fast-paced evolution of industrial technology.

Conclusion

An EU green taxonomy may help meet the increasing demand by institutional as well as retail investors for "sustainable" financial products. However, the existence of different taxonomies and labels is not a sign for a market failure but rather reflects the fact that there is not and cannot be an objective or common understanding of "sustainability". There is no need for public action by the EU to develop a public EU green taxonomy. The EU green taxonomy drives private taxonomies out of the market. If the EU were to develop an own taxonomy, its use should be optional, not mandatory. Any direct reference in financial market regulation for banks, insurance or investment firms to the green taxonomy should take place with caution, as sustainable investments may carry a high risk. First and foremost, financial market regulation should ensure financial stability.