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EU Taxonomy for Sustainability

Summary and Assessment

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In mid-December, following tough negotiations, the European Parliament and the Member States agreed on an EU taxonomy which provides a binding definition for environmentally sustainable activities and investments.

- ► The EU taxonomy leaves no room for other definitions of "sustainability" which could be stricter or more lenient or which could include other environmental objectives. This is inappropriate because investor preferences are not identical.
- ► How the taxonomy's abstract criteria will be defined remains an open question. Many of the issues which caused controversy between the Member States have not been resolved in the Regulation.
- ► The obligation for large companies of public interest to disclose the sustainability of their turnover, investments and expenditure involves a disproportionate amount of red tape and, in view of the information required, will also affect customers, purchasers and suppliers.
- ► "Sustainability" must not become an aim of financial market regulation in its own right. This could give rise to conflicts with the risk-based approach of financial market regulation and thereby jeopardise financial market stability.

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1 Four criteria for three classes of environmental sustainability

The EU Taxonomy Regulation[1] defines the mandatory criteria which will be used in future to define whether economic activities - and thus also investments therein - are "environmentally sustainable". The Regulation is directly applicable and requires no transposition into national law. Criteria for "social sustainability" will also be developed at a later date.[2]

"Environmentally sustainable" activities must comply with all of the following four criteria[3]:

(1) They must contribute "substantially" to at least one of the six environmental objectives defined in the Regulation.
(2) They must not "significantly" harm any of these environmental objectives.
(3) They must meet the "technical screening criteria" which define what "substantial" contribution and "significant" harm means for each environmental objective.
(4) They must comply with the "minimum safeguards" for employees.

These criteria are described in more detail below.

1.1 "Substantial" contribution to six environmental objectives

"Environmentally sustainable" activities must make a "substantial" contribution to at least one of six environmental objectives. In this regard, the Regulation differentiates between three classes of activity: Activities that are "sustainable per se" (Class 1), "enabling activities" (Class 2) and "transitional activities" (Class 3).

1.1.1 Class 1: Activities that are sustainable per se

The Regulation defines in each case when an activity "substantially" contributes to an environmental objective.

Objective 1: Climate change mitigation: The activity avoids or reduces greenhouse gas emissions or enhances their removal. As a means to achieving this objective, the following are mentioned, inter alia[4]:

- generating, transmitting or using renewable energy,
- investment in extending the power grid,
- more intensive and environmentally safe use of carbon capture and storage.

Objective 2: Adaptation to climate change: The activity includes adaptation solutions that[5]

- either substantially reduce the risk of the adverse impact of climate change or
- substantially reduce the adverse impact of climate change on this activity itself.

1 Unless otherwise indicated, the article numbers refer to the result of the trilogue negotiations on the new Taxonomy Regulation (Council Document 14970/19 ADD 1 of 17 December 2019).
2 Art. 17.
3 Art. 3.
4 Art. 6 (1).
5 Art. 7 (1) (a).

Objective 3: Sustainable use and protection of water and marine resources: The activity contributes to achieving the good status of water bodies or to preventing the deterioration of an existing good status. As a means to achieving these objectives, the following are mentioned, inter alia[6]:

- protecting the environment from the adverse effects of wastewater and contaminants such as pharmaceuticals and microplastics,
- protecting human health from the adverse impact of any contamination of water intended for human consumption,
- improving water efficiency, such as by promoting sustainable water use, based on long-term protection of available water resources.

Objective 4: Circular economy, waste prevention, re-use and recycling: The activity contributes to improving[7], inter alia:

- the efficiency in the use of natural resources, including resource and energy efficiency measures,
- the durability, reparability, upgradability, or reusability of products, in particular in design and manufacture,
- the recyclability of products, including of individual materials contained in products, inter alia through substitution or reduced use of products and materials that are not recyclable,
- the duration of use of products including through reuse, design for longevity, re-purposing, disassembly, re-manufacturing, upgrades, repair and sharing.

Objective 5: Avoidance and reduction of pollution: The activity contributes inter alia to[8]:

- preventing or - where not practicable - reducing pollutant emissions other than greenhouse gases into air, water or land,
- preventing or minimising adverse impacts on human health and the environment of the production, use and disposal of chemicals,
- cleaning-up litter and other pollution.

Objective 6: Protection and restoration of biodiversity and ecosystems: The activity contributes inter alia to[9]:

- conserving natural and biological diversity such as by achieving a "favourable conservation status" of natural and semi-natural habitats and species,
- sustainable land use and management,
- sustainable agricultural practices, such as by enhancing biodiversity or to halting and preventing the degradation of soil quality,
- sustainable forest management, such as by enhancing biodiversity or halting or preventing degradation of ecosystems.

[6] Art. 8 (1).
[7] Art. 9 (1).
[8] Art. 10 (1).
[9] Art. 11 (1).

1.1.2 Class 2: Sustainability by way of "enabling activities"

Although "enabling activities" cannot make the aforementioned contributions, they do "enable" a "substantial" contribution in other ways.[10] Classic examples are wind turbines or energy efficient household appliances. The following restrictions apply: The "enabling activity"

- must not lock assets in, to an extent that undermines long-term environmental goals,
- must - based on the entire lifecycle - have a substantial positive environmental impact.

1.1.3 Class 3: "Transition activities" for climate change mitigation (objective 1)

"Transition activities" are activities that do not fall into either Class 1 or Class 2 but nevertheless make a "substantial" contribution to climate change mitigation (objective 1) and may therefore be "sustainable". Transition activities are those for which there is no technologically and economically feasible low-carbon alternative[11] and

- whose greenhouse gas emissions are among the lowest in the sector or industry,
- do not hamper the development and deployment of low-carbon alternatives and
- do not - considering the economic lifetime of these assets - result in a dependence on carbon-intensive assets that is inconsistent with the objective of a climate-neutral economy.

1.2 No significant harm

Environmentally sustainable activities must not "significantly" harm any of the six environmental objectives set out above.[12] Such significant harm exists in the case of objective 1 (climate change mitigation), for example, where the activity results in "significant" greenhouse gas emissions.

In the case of objective 4 (circular economy, waste prevention, re-use and recycling) "significant" harm exists, for example, where the long term disposal of waste may cause significant and long-term harm to the environment.[13] This will be especially relevant for the classification of nuclear energy production as a sustainable transition activity.

1.3 Technical screening criteria

The Commission will specify detailed technical screening criteria in delegated acts which will be used to decide the circumstances under which an activity makes a "substantial" contribution to an environmental objective (1.1) or "significantly" harms it (1.2). The criteria are "regularly" reviewed, in the case of the criteria for transition activities "at least every three years".[14]

If possible, these criteria should be quantitative and contain threshold values. Energy production by using solid fossil fuels – coal, oil[15] – cannot be classified as "sustainable".[16] When specifying the criteria, the Commission will also take account of the market impact of the transition to a more sustainable economy.

[10] Art. 11a.
[11] Art. 6 (1a).
[12] Art. 12.
[13] Art. 12 (d).
[14] Art. 14 (4).
[15] Energy production by way of gas is not "unsustainable" per se. It depends on the greenhouse gas emissions arising in the individual case which differ depending on the technology (such as biogas or conventional gas power stations).
[16] Art. 14 (2a).

This includes the risk that assets will substantially decrease in value ("stranded assets"), as well as the risk of creating "inconsistent incentives" for investing sustainably and of an adverse impact on the financial markets.[17]

When developing the criteria, the Commission will consult a group of national experts which is specially set up for this purpose (Member States Expert Group).[18] Commission proposals for delegated acts with technical screening criteria are deemed to have been approved if there is no objection from the European Parliament or the Council of Ministers within two months (on request: four months). The Commission's power to adopt delegated acts with technical screening criteria may be revoked by Parliament or the Council of Ministers at any time.

1.4 Minimum safeguards for employees

Companies that carry out environmentally sustainable activities must observe:

- the OECD Guidelines for Multinational Enterprises, such as on dealing with trade unions, environmental protection, combating corruption and safeguarding consumer interests,
- the UN Guiding Principles on Business and Human Rights,
- the eight fundamental conventions of the International Labour Organisation (ILO), such as the ban on forced labour, freedom of association, equal pay for men and women for equal work and the ban on child labour.

2 Application of the taxonomy at product and company level

The Regulation makes it obligatory to apply the taxonomy. At product level, this applies to financial products that are marketed as "environmentally sustainable" (2.1). Transparency obligations when offering financial products are also subject to the taxonomy (2.2). Large companies of "public interest" must disclose the extent to which their activities are "sustainable" according to the taxonomy (2.3).

2.1 Environmentally sustainable financial products

All investment funds, pension products, insurance investment products and portfolios ("financial products")[19] as well as corporate bonds, that are marketed as "environmentally sustainable" must satisfy the requirements of the taxonomy. If the EU or Member States impose requirements with regard to "sustainable" financial products on administrators of investment funds, occupational retirement pension funds, insurance companies[20] and banks ("financial market participants")[21] or securities issuers, they must apply the taxonomy.[22]

2.2 Transparency obligations when offering financial products

Under the Disclosure Regulation [(EU) 2019/2088], which only came into force in mid-December 2019, the following applies: Firstly, financial market participants – both where they provide investment advice to

[17] Art. 14 (1) and Recital 28.
[18] Art. 16 (4) and Art. 16b.
[19] Art. 2 (12) Regulation (EU) 2019/288.
[20] This only includes insurance companies that offer insurance investment products (such as: life assurance), Art. 2 (1) Regulation (EU) 2019/288.
[21] Art. 2 (1) Regulation (EU) 2019/288.
[22] Art. 4.

clients[23] and where they invest their clients' money – must inform their clients in advance (ex-ante) as to whether and how they incorporate sustainability risks into their advice on investments and into their investment decisions.[24] Secondly, when it comes to financial products which envisage "sustainable investments" or "environmental or social characteristics"[25], financial market participants must also provide regular information, even after conclusion of the contract (ex-post), regarding the product's sustainability impact.[26]

The Taxonomy Regulation substantiates these ex-ante and ex-post transparency obligations.

- Financial market participants and financial advisers must apply the criteria of the taxonomy when meeting their transparency obligations regarding financial products which have "sustainable investment" as their object. This means they must communicate
  - which of the six environmental objectives of the Taxonomy Regulation is the object of the investment,
  - what proportion of the funds of the financial product is invested in activities that are deemed to be "sustainable" according to the taxonomy. The proportion of "enabling activities" and "transition activities" must be reported separately in this regard.[27]

- Financial market participants and financial advisers only have to apply some of the criteria of the taxonomy when meeting their transparency obligations regarding financial products which only have "environmental or social characteristics" as their object. This means they must communicate
  - what proportion of the investment (if any) is sustainable according to the taxonomy; which environmental objectives under the Taxonomy Regulation are envisaged and what proportion of the investments is made up of "enabling activities" and "transition activities",
  - that the criteria of the Taxonomy Regulation are not taken into account for the remaining part of the investment and that significant harm to other environmental objectives cannot be ruled out.[28]

- Financial market participants and financial advisers do not have to apply the criteria of the taxonomy when meeting their transparency obligations regarding financial products which do not envisage any "sustainable investments" or "environmental and social characteristics". They must, however, indicate that such products do not take account of the EU criteria for environmentally sustainable investments.[29]

2.3 Transparency obligations for companies of public interest

"Companies of public interest" are

- all banks and insurance companies,

23 As "Financial advisers" under Art. 2 (11) Regulation (EU) 2019/2088, this includes insurance brokers that are not "financial market participants".
24 Art. 6 Regulation (EU) 2019/2088.
25 The latter financial products have a lower level of ambition and do not necessarily take account of the fact that the pursuit of one environmental characteristic may be detrimental to other environmental characteristics.
26 Art. 11 Regulation (EU) 2019/2088.
27 Art. 4alfa.
28 Art. 4beta.
29 Art. 4gamma.

- all companies with publicly traded securities and
- all other companies classified as such by a Member State

that have a specific legal from (a.o. “Aktiengesellschaft” in Germany, “société anonyme” in France or “public limited company” in the UK).[30]

These companies must disclose the extent to which their activities are “sustainable” within the meaning of the taxonomy.

The disclosure obligation only applies where these companies have more than 500 employees. In addition, their total assets must amount to more than € 20 million or their annual turnover to more than € 40 million.[31]

These companies must indicate[32]

- the proportion of their turnover and
- the proportion of their “total investments and/or expenditures”[33]

that are “associated with”[34] activities that are “sustainable” according to the taxonomy.

The EU Commission will specify more details by way of delegated acts and in so doing differentiate between financial companies and other companies.[35]

2.4 Timetable

The Commission will adopt the technical screening criteria for objectives 1 and 2 (climate change mitigation and adaptation to climate change) by the beginning of 2021, by way of delegated acts. These and the related transparency obligations for financial market participants and financial advisers will apply as of 2022. The technical screening criteria for the other targets will apply as of 2023.

3 Assessment

Due to varying preferences and varying weighting given conflicting objectives, a generally accepted definition of “sustainability” is not possible. The EU taxonomy should have taken that into consideration by leaving room for other definitions of “sustainability” which could have been stricter or more lenient or which could have included other objectives. The risk of misleading investors (“greenwashing”) could have been overcome by way of transparency obligations.

Whether this taxonomy is going to convince investors at all therefore remains to be seen. It is also unclear how the taxonomy’s abstract criteria will be defined. Many controversial issues, arising not least from the varying preferences in the EU Member States, have not been resolved by the Regulation and must now be settled by way of the Commission’s delegated acts. The question of whether nuclear energy can be sustainable will be a test case in this regard.

30 For a full list, see Annex I Directive 2013/34/EU.
31 Art. 4delta (1) in conjunction with Art. 2 (1) and Art. 3 (4) of Directive 2013/34/EU.
32 Art. 4delta (2).
33 Art. 4delta (2) (b), “the proportion of their total investments (capital expenditure) and/or expenditures (operating expenditure related to … sustainable economic activities”.
34 Art. 4delta (2) (a).
35 Art. 4delta (4).

Irrespective of how the Commission answers the questions: A certain proportion of European investors will see the result as a failure to take account of their sustainability preferences and will place little confidence in the European sustainability label.

The creation of “enabling activities” and “transition activities” as additional classes of sustainable activities partially compensates for the disadvantage of a full harmonisation of the concept of sustainability. The additional classes allow for differentiation between financial products and investments. However, here too the question arises as to why other private assessments, of whether activities can be regarded as “enabling activities” or “transition activities”, are excluded.

Transparency obligations for larger companies of public interest are to be be rejected. Since these companies will only be able to meet these transparency obligations if their customers, purchasers and suppliers provide them with information about the “sustainability” of their activities, in reality these obligations will affect not only large companies of public interest. Not only does compliance with these obligations involve a disproportionate amount of red tape, there is also no convincing justification for the obligations. It is possible that some companies, due to pressure from investors and/or customers - and thus out of self-interest - will publish this information. Companies that do not experience such pressure or do not expect any financial gain from transparency should, however, be able to forego disclosure.

The real reason for the transparency obligation is likely to be something else: In a second step, the taxonomy is to be more firmly incorporated into financial market regulation in order to increase its ability to channel investment. It is expected that banks, for example, will in future be forced to pay more attention to the sustainability of their corporate clients when it comes to lending. Extreme caution is required when introducing such external - in this case “sustainable” - objectives into financial market regulation. If it softens the risk-based approach of financial market regulation it will jeopardise financial market stability. Although sustainability aspects are currently already relevant when assessing companies’ credit worthiness, e.g. because transition risks due to climate policy[36] or physical risks caused by the climate[37] can adversely affect a company, a company’s sustainability is no indication of its creditworthiness per se. If “sustainability” becomes an aim of financial market regulation in its own right this will amount to tacit acceptance of an increased risk to financial market stability.

[36] Transition risks arise from the shift to a low-carbon economy and result in particular from political decisions (such as: CO_2 pricing), technological changes (such as: replacing the combustion engine with electric motors) or changes in customer preferences.

[37] Physical risks arise from extreme weather events or long-term climatic changes.