

Green Taxonomy

The Position of the EU-Parliament

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On 28 March 2019, the EU-Parliament voted on the Commission’s proposal to establish a framework for sustainable investments. This cepAdhoc presents and assesses the amendments proposed.

- Like the Commission, the Parliament misinterprets the existence of different taxonomies and labels as market failure, rather than as a reflection of the fact that there is no objective or common understanding of “sustainability”. At the same time, the Parliament rightly makes clear that the taxonomy shall not apply to financial products, which explicitly do not “pursue sustainability”.
- As many economic activities are complex, the Parliament’s move away from a binary approach, i.e. activities are either sustainable or not, is to be welcomed.
- The Parliament rightly chose not to introduce a brown taxonomy for “non-sustainable activities”. However, its decision to define three activities as outright not-sustainable is not consistent with this approach.
- The enforcement role allocated to the European Supervisory Authorities (ESAs) is not convincing as the ESAs do not have the necessary expertise to identify breaches of the taxonomy regulation.
- Raising “minimum safeguards” regarding labour and human rights standards is a political decision. It remains to be seen whether these safeguards reflect the preferences of the investors. It may be difficult for enterprises to ensure compliance with the “minimum safeguards”.

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Table of Contents

1 Introduction	3
2 Broader Scope of the Regulation	3
2.1 Changes by the Parliament	3
2.2 Assessment	4
3 Inconsistent Rejection of a brown Taxonomy	4
3.1 Changes by the Parliament	4
3.2 Assessment	4
4 Additional Powers for European Supervisory Authorities	5
4.1 Changes by the Parliament	5
4.2 Assessment	5
5 The assessment of sustainability	6
5.1 No binary Approach to environmental sustainability	6
5.1.1 Changes by the Parliament	6
5.1.2 Assessment	6
5.2 A broader concept of significant harm to the environment	6
5.2.1 Changes by the Parliament	6
5.2.2 Assessment	6
5.3 Higher minimum Safeguards for labour and human Rights	7
5.3.1 Changes by the Parliament	7
5.3.2 Assessment	7
5.4 Harmonised Measuring of the substantiality of the environmental impact	7
5.4.1 Changes by the Parliament	7
5.4.2 Assessment	8

1 Introduction

On 28 March 2019, the European Parliament approved at first reading the Commission's proposal¹ to establish a framework to facilitate sustainable investments (cf. [cepPolicyBrief](#)), which sets out the criteria that economic activities – and hence also investments in these activities – must comply with to qualify as “environmentally sustainable”.

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

Due to a large number of amendments by the Parliament, the text now differs substantially from the proposal drafted by the Commission. This **cepAdhoc** illustrates and assesses the main changes.²

The amendments discussed here are not final. Before the regulation can enter into force, the Parliament will have to agree on all changes with the Council, which has not yet adopted a position on the file.

2 Broader Scope of the Regulation

2.1 Changes by the Parliament

The scope of the Regulation is broadened with respect to the Commission's proposal. While the latter only addressed those financial market participants that claim to market sustainable products, the text approved by the Parliament applies to all financial market players, but distinguishes between different financial products.

The Parliament confirms the Commission's approach that, whenever an EU or national measure establishes requirements concerning the marketing of sustainable products, such requirements will have to be modelled on the criteria set by the Regulation. For these products, compliance with the taxonomy will hence be obligatory.

The Parliament makes clear that the taxonomy will not apply to financial market participants, which do not market financial products as environmentally sustainable or having similar characteristics. It does however state that they must

- (1) provide evidence that the funded activities “do not have any significant sustainability impact” using the criteria laid down by the regulation or
- (2) declare in the prospectus that the related financial product does not pursue sustainable objectives and, thus, may finance activities which are non-sustainable according to the regulation.³

¹ Proposal COM(2018) 353 of 24 May 2018 for a Regulation on the establishment of a framework to facilitate sustainable investment.

² Quotations in this paper refer to (1) the European Parliament legislative resolution of 28 March 2019 on the proposal for a regulation of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment ([P8_TA\(2019\)0325](#)) (“EP-Resolution”) and (2) the provisional agreement resulting from interinstitutional negotiations concerning the Review of the European Supervisory Authorities (“ESA-Review”, [PE637.424v01-00](#)).

³ Art. 1(2) (ba) EP-Resolution.

2.2 Assessment

Like the European Commission, the European Parliament misinterprets the existence of different taxonomies and labels as a sign of market failure, rather than a reflection of the fact that there is not and cannot be an objective or common understanding of “sustainability”.

At the same time, the Parliament rightly makes clear that the taxonomy will not apply to financial products which are explicitly “not pursuing sustainability”. This does not change the fact however, that the Parliament as well intends to adhere to the obligatory – instead of optional – character of the taxonomy for all financial products pursuing “sustainability”. It hence “monopolises” the definition of “sustainability” and eliminates different – public and/or private – concepts of sustainability, which do have a right of existence, given different preferences regarding sustainability of investors.

This is all the more serious, given that the Commission intends to first define “sustainability” focussing on (parts) of the environmental aspects only and to neglect social and governance aspects for the time being. In the meantime, activities with a focus on social or governance aspects which investors might find “sustainable”, cannot be named and marketed this way.

3 Inconsistent Rejection of a brown Taxonomy

3.1 Changes by the Parliament

The Commission’s proposal aimed at identifying economic activities that are environmentally sustainable (positive approach). In no way does it aim at determining which activities are environmentally unsustainable.

The Parliament follows the same approach but establishes that the Commission shall assess the consequences of identifying non-sustainable activities (“brown taxonomy”) by the End of 2021. It does not, however demand the Commission to propose criteria to identify brown activities.⁴

At the same time, the Parliament lists three activities that, irrespective of the results stemming from the application of the taxonomy, cannot be “sustainable”⁵:

- power generation activities that use fossil fuels;
- activities contributing to carbon intensive lock-in effects;
- power generation activities producing non-renewable waste.

3.2 Assessment

Given that it is unconvincing for the taxonomy to be mandatory for all “sustainable” activities, the Parliament’s decision to not introduce a brown taxonomy is to be welcomed. Economic activities should not be stigmatised as “not sustainable” when there is no common understanding of “non-sustainability”. The Parliament’s decision to define three activities as outright not-sustainable is not consistent with this approach.

⁴ Art. 3(a) EP-Resolution.

⁵ Art. 14(2a), (2b) and (2c) EP-Resolution.

4 Additional Powers for European Supervisory Authorities

4.1 Changes by the Parliament

Contrary to the Commission's proposal, the Parliament gives supervisory powers to the European Supervisory Authorities (ESAs) – for banks (EBA), insurances (EIOPA) and security firms (ESMA) – in the field of financial products marketed as environmentally sustainable.

The EP gives the ESAs the power to⁶

- monitor the market for financial products marketed as environmentally sustainable and
- temporarily prohibit or restrict the marketing, distribution or sale of these products when there is a breach of the taxonomy regulation.

Parallel to discussions on the taxonomy regulation, a triilogue agreement on the ESA-Review has been reached. In that review, the relevant competences of the ESAs have been moderately broadened. In the case at hand, the EP's resolution in combination with the ESA-Review means that for financial products marketed as environmentally sustainable⁷:

- ESAs may adopt guidelines and recommendations in order to promote the safety and soundness of sustainable finance markets and to promote the convergence and "effectiveness" of regulatory and "supervisory" practices;
- ESAs may prohibit products in breach of the taxonomy regulation when they threaten the integrity and functioning of financial markets and when such breaches "have the potential to cause significant financial damage to customers".

All ESAs' decisions take precedence over any decision taken by a national authority.

4.2 Assessment

Installing a pan-European definition of "sustainability" (which is not convincing, see above) makes it necessary to ensure that the concept will be used in a consistent way across the EU. Hence, the Parliament's decision to enable intervention by European authorities is logical.

However, in the ongoing legislative process it must be made clear, which of the three supervisory authorities (EBA, EIOPA or ESMA) will be responsible in a given case. For example, it must be made clear which authority will be in charge if, e.g., an insurance company (EIOPA's competence) markets and falsely claims an insurance product investing in bonds (ESMA's competence) to be "sustainable".

Also, the exact scope of the enforcement role given to the ESAs is not clear. Should the ESAs only react to a finding by national supervisory authorities that there is a breach of the taxonomy regulation and then restrict the sale of the product; or should they themselves be entitled or bound to identify such breaches? Neither national financial supervisors nor the ESAs possess the necessary technical expertise on climate and environmental matters to identify breaches of the taxonomy regulation. This problem may become even more pressing as soon as the taxonomy covers social and governance questions in the future. Without a consistent detection and punishment of breaches of the regulation, the ESAs competencies may remain of limited practical significance.

⁶ Art. 4(2)a EP-Resolution.

⁷ New Art. 9(2) and 9(5) of the ESA-Regulations, ESA-Review.

5 The assessment of sustainability

5.1 No binary Approach to environmental sustainability

5.1.1 Changes by the Parliament

The Commission proposed a binary concept of sustainability, i.e. activities are either sustainable or not. The Parliament, instead, acknowledges that an activity can achieve various degrees of sustainability and that the criteria set forth by the regulation shall be used to identify its “degree of environmental impact and sustainability”.⁸

5.1.2 Assessment

The Parliament’s change is to be welcomed. Many economic activities are complex and binary decisions on their (non)sustainability very often is not possible. Also, a binary approach may be well suited for “green” project bonds, but not for equity, as enterprises may engage in activities of different degrees of sustainability.

5.2 A broader concept of significant harm to the environment

5.2.1 Changes by the Parliament

The Commission proposed that “environmentally sustainable” economic activities must not significantly harm any of the six environmental objectives enumerated by the Regulation.⁹

In its resolution, the Parliament upholds this approach but adds that any assessment of harm of an activity must encompass the impact of the products and services provided by the activity under consideration. As a consequence, the assessment must take into account the “entire life cycle” of activities – and the related products and services, even “throughout the value chain” when necessary.¹⁰

5.2.2 Assessment

The Parliament’s clarification is consistent but pinpoints the enormous difficulty of assessing the “sustainability” of activities. One given activity may produce products or services whose environmental impact (and hence sustainability) may be very different. Steel products may be used in nuclear power plants as well as wind turbines. Reaching a commonly accepted judgement on the sustainability of such activities is not possible (even more given that there is not a commonly accepted understanding of sustainability) and only illustrates why there is no need for public (instead of private) action – here by the EU – to develop a public EU green taxonomy.

⁸ Art. 1(1) EP-Resolution.

⁹ These environmental objectives are: (1) climate change mitigation, (2) climate change adaptation, (3) sustainable use and protection of water and marine resources, (4) transition to a circular economy, waste prevention and recycling, (5) pollution prevention and (6) control and protection of healthy ecosystems.

¹⁰ Art. 12 (1a) EP-Resolution.

5.3 Higher minimum Safeguards for labour and human Rights

5.3.1 Changes by the Parliament

The Commission proposed compliance with the International Labour Organisation's Declaration on Fundamental Rights and Principles at Work ("ILO Declaration") as a pre-condition for an economic activity to be considered as sustainable under the taxonomy framework.

The Parliament goes further and requires observance of the OECD Guidelines for Multinational Enterprises and UN Guiding Principles on Business and Human Rights, which include the rights mentioned by the ILO Declaration and the International Bill of Human Rights. The Parliament prompts the Commission to work out criteria for assessing compliance by the end of 2020 and to assess the impact of extending these minimum safeguards by December 2021.¹¹

5.3.2 Assessment

Setting the level of ambition regarding minimum safeguards is a political decision. If the EU-sustainability label is to be accepted by investors, this decision should reflect the preferences of the public. Whether it does remains to be seen.

It remains unclear whether the minimum safeguards apply only to the direct activity of an entrepreneur or whether also subcontractors will be covered. Given complex supply chains and the use of intermediate products from different subcontractors in many different countries across the world, it may be difficult for enterprises to ensure that they meet the "minimum safeguards", e.g. on equal remuneration or non-discrimination on a global basis.

5.4 Harmonised Measuring of the substantiality of the environmental impact

5.4.1 Changes by the Parliament

The Commission proposed to use technical screening criteria to verify whether the contribution or the harm produced by an economic activity to the environment must be considered as "substantial" under the Regulation. This is decisive for defining the activity as "sustainable".

The Parliament wants such technical screening criteria to be based on harmonised indicators, which measure the environmental impact of the economic activity "using a harmonised life cycle assessment", i.e. taking into account

- the production – from the use of raw materials to the final product-, the use and to possibility of recycling of products;
- whether an activity is "in transition to a sustainable configuration [...] through research and innovation projects, specific timelines and pathways of transition";
- whether "the major part" of companies undertaking a certain activity "are evidently engaged in a trajectory towards" sustainability; this can be demonstrated through "sustained research and development efforts, large investment projects in [...] more sustainable technologies or concrete transactions plans in at least the early stages of implementation".

¹¹ Art. 13 EP-resolution.

5.4.2 Assessment

The Parliament eases the technical screening criteria in order to make it more likely that a given economic activity (e.g. car manufacturing) will be found to be “sustainable”. This fits well to the non-binary approach adopted by the Parliament. It remains to be seen whether this will convince investors and help to provide financial funds to activities in transition towards sustainability or whether investors will see this as “green-washing” – i.e. misleading investors by falsely claiming an activity to be sustainable. Again, this speaks in favour of allowing private entities to give their own, diverging assessments of the grade of sustainability of a certain activity.