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Responsible Investing

EU Taxonomy: a pathway to superior corporate sustainability

The European Union's bid to create a common framework to support the Green Deal is also an opportunity for asset managers

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Climate change is arguably the greatest challenge the world currently faces. Delivering on the 2015 Paris Agreement goal to limit global warming to 1.5°C-2°C compared to pre-industrial levels will require enormous investment. The OECD estimates that $6.9trn a year is required up to 2030, to meet climate and development objectives, adding further pressure to the financing of the United Nation's broader Sustainable Developments Goals (SDGs)[1].

The first real wake-up call on the urgency of tackling climate risk in the financial sphere was given by the then Bank of England Governor Mark Carney in 2015. This helped to spark increased coordination among governing bodies and regulators to address this systemic issue. In that context and as part of the European Union (EU) action plan on financing sustainable growth published in March 2018, the finance industry has thus been required to redirect financial flows towards sustainable projects and activities.

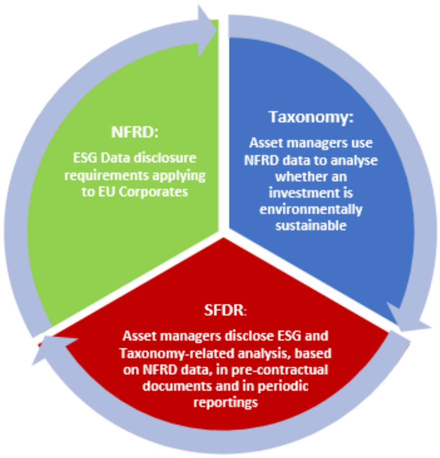
This evolution has created a need for a common classification system for sustainable economic activities: the EU Taxonomy. Its goal is to help companies plan the transition, to mitigate market fragmentation and to protect private investors from so-called 'greenwashing' – where sustainability ambitions and language are not matched by action and outcomes.

The Taxonomy is part of the EU Taxonomy Regulation (Regulation (EU) 2020/852), which was published in the Official Journal of the EU in June 2020. It sets out a framework to facilitate sustainable investment, to support the EU's climate and energy targets for 2030 and to reach the objectives of the European Green Deal[2].

[1] *Organisation for Economic Co-operation and Development (OECD). Financing Climate Futures: Policy Highlights 2018*

[2] *The European Green Deal has three key objectives: a) Reorient capital flows towards sustainable investment to achieve sustainable and inclusive growth; b) Manage financial risks stemming from climate change, environmental*

The Green Deal has far-reaching impacts, and is implemented via several intertwined regulations, which include the EU Taxonomy Regulation, as well as the Sustainable Finance Disclosure Regulation (SFDR) and the Non-Financial Reporting Directive (NFRD). These regulations (see graphic below) create new sustainability-related disclosure requirements in the financial sector via SFDR, and for certain large corporates, banks and insurance companies, via the NFRD.



Source: AXA IM

The purpose of this paper is to focus on the European Taxonomy framework and on some key aspects of NFRD and SFDR, to highlight how the Taxonomy Regulation can be an opportunity for asset managers whether by facilitating our assessment of companies' sustainability, or by underpinning the design of sustainable products or funds.

We will first review what the Taxonomy Regulation is about, its objectives and timeframe, before discussing key content including supplementary technical criteria for determining sustainability effects. Our third section will aim to make concrete assessments of how the new rules can guide investor views of corporate sustainability to inform investment decisions.

Importantly, we highlight that beyond climate and broader environmental issues, the Taxonomy Regulation also encompasses a strong focus on human rights, requiring economic activities to comply with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights, including the core international human rights treaties and International Labour Organisation instruments.

I. Taxonomy Regulation: objectives and timeframe

The Taxonomy Regulation has four key objectives:

- Provide clarity through a framework to determine eligible environmental activities with relevant criteria
- Measure the degree of sustainability of an investment and the degree of green activities of companies
- Report on the transition, by setting objectives and a direction of travel for different economic activities
- Help to translate commitments to the Paris Agreement and the UN SDGs

To whom does it apply?

Financial Market participants: SFDR or sustainability-related disclosures in the financial services sector require financial markets participants to evaluate and disclose sustainability-related data and policies at entity, service and product level. It applies to anyone offering financial products in the EU,

Source: Taxonomy: Final report of the Technical Expert Group on Sustainable Finance

regardless of where the manufacturer of such products is based.

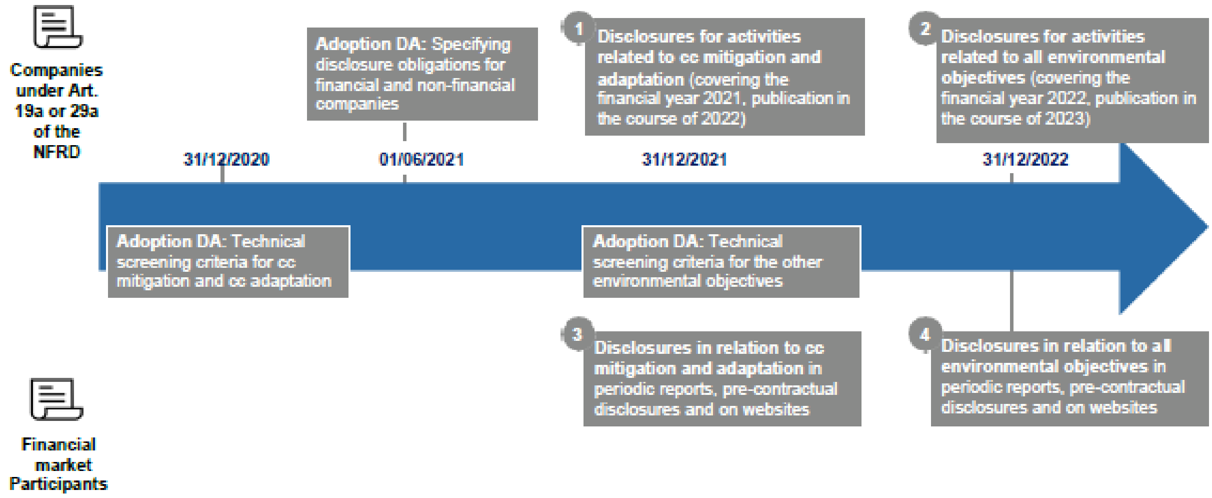
Large Corporates: Companies within the scope of the NFRD will be required to disclose how and to what extent their activities – regardless of their location – are aligned with the EU taxonomy as of 1 January 2022, starting with the climate objectives. It includes information about their business model, policies, risks and risk management, and key performance indicators (KPIs) related to their business.

degradation and social issues; and c) Foster transparency and long-termism in financial and economic activity.

The European Commission will complement and further specify these disclosure obligations in a delegated act to be adopted by 1 June 2021.

What is the timeframe?

As set out in the Taxonomy Regulation, financial market participants and companies falling under the scope of the NFRD will be required to disclose the degree of alignment of their activities and financial products with the EU Taxonomy, as set out below:



Source: *Taxonomy: Final report of the Technical Expert Group on Sustainable Finance*

As for NFRD, the disclosure requirements start applying on 1 January 2022 in relation to the climate objectives, and on 1 January 2023 in relation to the other four environmental objectives. The reporting covers the previous financial year respectively, meaning that the first reporting is due in the course of 2022 for the financial year 2021 related to climate change mitigation and adaptation, and in the course of 2023 for the financial year 2022 for all environmental objectives.

Some challenges

The EU's Technical Expert Group (TEG) recognizes that the timeline presents challenges to implementation, as corporate disclosures will not be available for financial market participants to use in their 2021 disclosures.
An expanded set of disclosures covering activities that substantially contribute to all six environmental objectives will be required by the end of 2022.

II. The European Taxonomy and Delegated Acts

The European taxonomy aims to define the criteria and the conditions that an economic activity has to meet in order to qualify as environmentally sustainable.

What are environmentally sustainable activities?

- An environmentally sustainable activity contributes substantially to one or more of the following environmental objectives:
    a) Climate change mitigation
    b) Climate change adaptation
    c) The sustainable use and protection of water and marine resources
    d) The transition to a circular economy
    e) Pollution prevention and control
    f) The protection and restoration of biodiversity and ecosystems
- It does not significantly harm any of the other environmental objectives – the 'do no significant harm'

(DNSH) principle – ensuring that progress against some objectives are not made at the expense of others.

- **It complies with the minimum safeguards set out in the OECD guidelines** for Multinational Enterprises and the International Labour Organization
- **It complies with the technical screening criteria developed by the Technical Expert Group in the form of Delegated Acts** (applicable from 1 January 2022 for Climate-related objectives and from January 2023 for the other environmental ones)

In other words, the Taxonomy defends a comprehensive sustainability model, and is not a single topic focused on climate change. Any contribution to its mitigation or adaptation must not be at the expense of biodiversity of social concerns. The DNSH principle is, for instance, at stake in the case of large hydroelectric dams, which although providing a low-carbon-intensive source, entail massive land and biodiversity destruction when covering thousands of square kilometres of land.

Going forward, the Taxonomy should also incorporate other dimensions such as social objectives.

What are the delegated acts?

In order to support the assessment of sustainable activities, the European commission has established **the delegated acts** – supplements to the Taxonomy – which determine:

- which activities make a substantial contribution to climate change mitigation and adaptation, through a set of technical screening criteria (TSCs).
- The detailed technical screening criteria (metrics, thresholds): see annex for an example.

TSCs for activities that make a significant contribution to water, circular economy, pollution prevention and control, and protection of ecosystems will be issued by the end of 2021.

Those TSCs have been defined in collaboration with the TEG on sustainable finance. The TEG was replaced by the Platform on Sustainable Finance at the end of 2020, bringing together experts from the corporate and public sector, from industry as well as academia, civil society and the financial industry. The aim of this Platform is to enable cooperation between a wide range of stakeholders and to assist the European Commission in the further development of the EU Taxonomy.

Which activities are covered by Taxonomy?

Economic sectors and economic activities included in the Taxonomy can make a substantial contribution to climate change mitigation or climate change adaptation.

For climate change mitigation, sectors responsible for 93.5% of direct greenhouse gas (GHG) emissions in the EU were prioritized when identifying economic activities for which TSCs were developed.

The identification of eligible activities under the Taxonomy will be done on the basis of their NACE code (Nomenclature des Activités Economiques dans la Communauté Européenne). The TEG provided an Excel spreadsheet mapping the NACE classification system against the Bloomberg Industry Classification System (BICS) and the Thompson Reuters Business Classification system (TRBC).

Points of note:

- Formal certification or audit verification of Taxonomy-related disclosure is not explicitly required although encouraged
- The use of the Taxonomy by non-European actors should be encouraged for level playing fields reasons
- Financial market participants face a challenge in reporting on their non-European activities

The technical screening criteria (TSCs)

To complement the notion of eligibility, the TEG has developed TSCs for 70 activities in eight sectors of the economy contributing to climate change mitigation, as well as for 68 activities contributing to climate change adaptation.

The technical screening criteria for transitional activities will be reviewed at least every three years and for other activities at least every five years, meaning that a tightening of the criteria for certain economic activities, previously considered Taxonomy-aligned, would make them lose their eligibility.

Feedback from the European Fund and Asset Management Association was summarised in a feedback paper published on 18 December, 2020. Those recommendations concern various themes or segment of activities and address various types of challenges, such as level playing field, timeframe and ESG (environmental, social an governance) data challenges.

Where no TSCs for economic activities exist yet, companies are encouraged to use their own metrics and explain how these relate to the EU Taxonomy. However, such economic activities would not be considered Taxonomy-aligned.

As for the DNSH principle, TSCs have been developed covering climate change adaptation, pollution prevention and control, water and protection of marine resources, circular economy, resource efficiency and recycling, and the protection of ecosystems.

Sustainable Green, Transitional or Brown activities?

Beyond green or environmentally sustainable activities, the Taxonomy also defines the conditions under which an activity can be considered as "Transitional", i.e. contributing substantially to the environmental objective of climate change mitigation. It requires activities to have GHG emissions levels corresponding to the best performance in the sector/industry, whilst not hampering the deployment of low-carbon alternatives and not favouring short-term reduction to the detriment of long-term goals.

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Although stringent, the definition of "Transitional" activities still provide "Brown" or high-emitting sectors with the ability to adapt business models, whether through capital expenditure (capex) dedicated to climate change mitigation, or through their own activities, providing they respect some strict criteria. See tables in the annex with the example for the manufacture of iron and steel.

Meanwhile, lobbying remains intense from Brown sectors to include some activities in the Taxonomy. Suggestions that the European Commission could introduce gas in the Taxonomy, under strict conditions including around emissions reductions and CO2 intensity, had triggered vocal reactions from WWF Europe as well as from some members of the Platform on Sustainable Finance.

A final decision on whether nuclear and gas would be included on the so-called "green list" of sectors that can contribute to transition/decarbonization has been put off until later in 2021[3].

Finally, we note that Taxonomy Regulation includes a review clause for year-end 2021, potentially extending the current taxonomy to significantly environmentally harmful activities ("brown" activities) as well as activities that do not have a significant impact on environmental sustainability (low impact activities).

III. Taxonomy Regulation as a guide to frame the assessment of corporates' sustainability and inform investment decisions

NFRD amendments set out specific guidelines to support climate risks assessments

The disclosure of non-financial information is considered vital for managing change towards a sustainable global economy, by combining long-term profitability with social justice and environmental protection.
The objective of the EU's NFRD is to increase the transparency of the social and environmental information provided by companies. The on-going revision of the regulation will help ensure this information becomes more standardized and mandatory, requiring companies to disclose information on how and to what extent their activities are Taxonomy-compliant. It concerns firms with more than 500 employees (about 6,000 companies across Europe).

Companies must report on:

- the proportion of turnover derived from products or services associated with environmentally sustainable activities
- the proportion of capex and operating expenditure (opex) related to assets or processes associated with environmentally sustainable activities

What about verification?

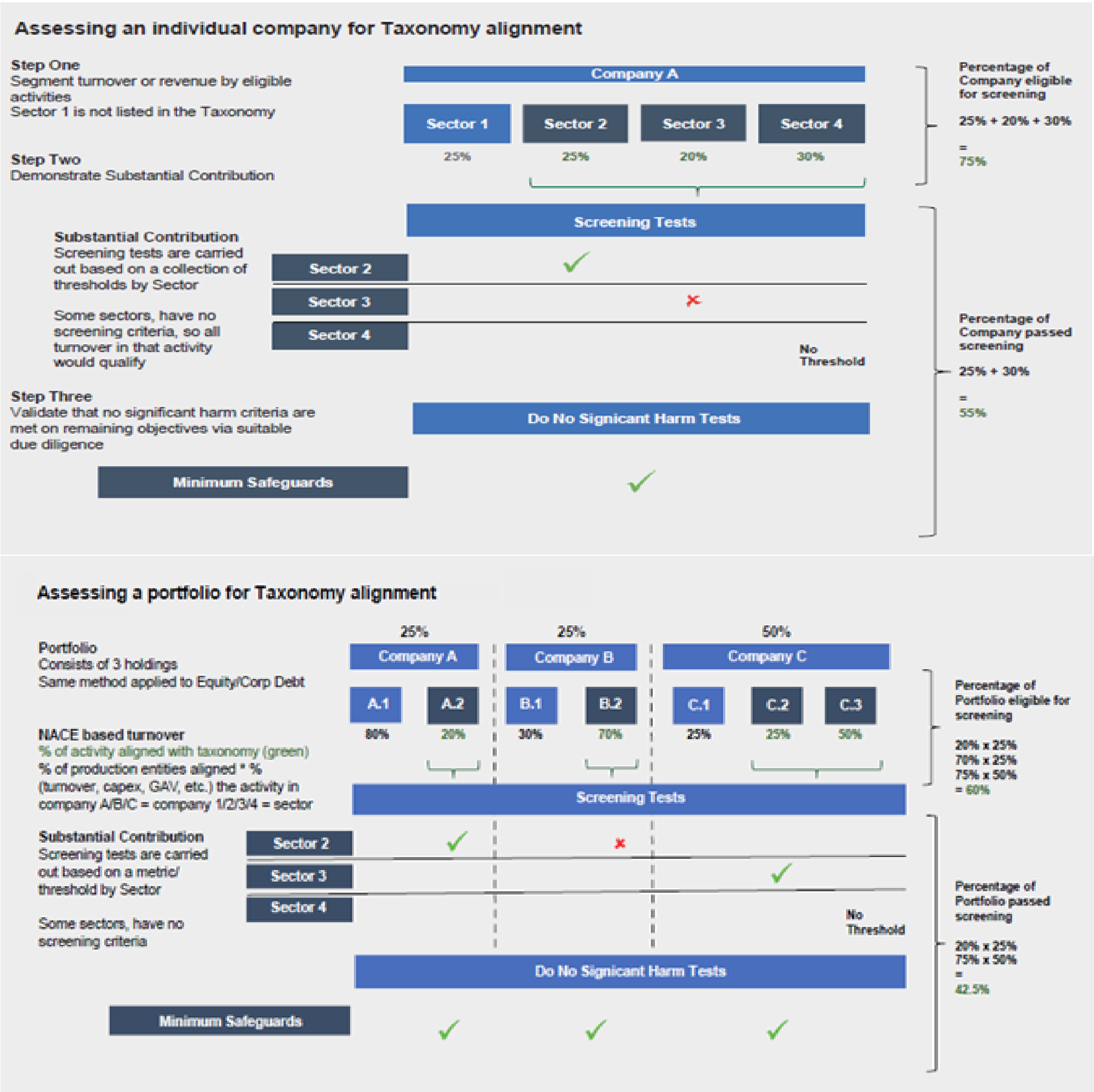
The Regulation does not require verification of the information disclosed. However, this may be subject to change depending on the outcome of the on-going NFRD review, as well as on the transposition of the Regulation by member states. The Commission will evaluate the need for setting-up mechanisms verifying compliance with the Taxonomy criteria by autumn 2022.

[3] *https://www.powermag.com/reprieve-for-nuclear-gas-in-eus-sustainable-finance-taxonomy-rules/*

Timeline and challenges

The first publications under NFRD are due in 2022. This contrasts with financial market participants under the Taxonomy, that are required to complete their first set of disclosures by 31 December 2021. The Commission will adopt delegated acts by 1 June, 2021, specifying how the corporate disclosure obligations should be applied in practice. However, implementation is not clear cut as a revised NFRD is expected for Q2 2021, extending disclosure requirements from the environmental to social thematics.

How will it work in practice? At company or portfolio level



Source: TEG final report on taxonomy

The second table on the preceding page sets out the different steps enabling identification of the share of a portfolio that can be classified as environmentally sustainable:

- For each of those companies and its activities, the share of turnover aligned with the Taxonomy is calculated: in the example above, 20% for company A, 70% for company B, and 75% for company C
- This in turn determines the percentage of turnover/activities eligible for technical screening.
    - As shown in the second row, for company A, the 20% activities aligned with the Taxonomy pass the technical screening criteria (TSCs) and are thus considered as environmentally sustainable
    - However, for company B, the 70% activities aligned with the Taxonomy do not meet the corresponding TSCs and hence do not count as environmentally sustainable.
    - Meanwhile, activities that do not have TSCs (but that are listed in the Taxonomy) would qualify.

In this example, at the portfolio level, the share of sustainable activities corresponds to those passing the screening tests. The analysis gives us a final result of 42.5%.

How does SFDR interact with the Taxonomy Regulation?

The Taxonomy Regulation amends the Sustainable Finance Disclosure Regulation (SFDR) by setting additional disclosure obligations on financial markets participants making products investing in Taxonomy-eligible activities. It sets out different pre-contractual and periodic reporting for Article 8 and Article 9 products (respectively promoting environmental taxonomy characteristics and environmental taxonomy objectives).

Our purpose here is not to dig into SFDR, but to highlight which components of the reporting requirements can be useful information to inform investment decisions.

They result notably from:

- The consideration of sustainability risks deriving from environmental or social issues
- The consideration of principal adverse impacts (PAI) on sustainability factors; these are the negative effects on environmental, social and employee matters resulting from an investment decision.

In particular, financial market players will have to determine the extent to which the underlying assets of a fund with environmental objectives are expected to be Taxonomy-aligned and to report on the actual figures in the periodic reporting.

Discussions are still on-going, as of April 2021, with regards to the methodology to be used, whether to calculate the “alignment” KPIs with turnover, capex and opex proposed as options.

Our view is that flexibility will be essential as a start, considering the fact that issuers may choose to report on one or the other KPI, but also the fact that the most relevant KPI may not be the same depending on the level of greenness of the company (Taxonomy-aligned or in transition). In practice, implementation challenges remain significant as the final criteria of the Taxonomy are not yet known, and there is no historic data to help define what is a meaningful proportion of assets.

Additional disclosure details are also required for funds with sustainability objectives, such as, on the environmental front: CO2 Scope 1, 2 and 3, carbon footprint, weighed-average carbon intensity, solid fossil fuel exposure, energy consumption related to non-renewable energy sources compared to renewables.

Integration of those indicators at a bottom-up level and on a sectoral basis should help portfolio managers “rank” issuers accordingly and facilitate investment decisions.

Here also, implementation challenges remain, as the information may not be reported by issuers based on similar methodologies, or even may not be reported at all. The NFRD revision will be of help to solve this issue.

Conclusion

The European Taxonomy will prove key in the context of the Commission’s Green Deal, which intends to mobilize at least €1trn of sustainable investments by 2030 as part of the transition to a climate-neutral, greener, more competitive and inclusive economy.

Although regulation will induce upfront costs in the short term, for companies exposed to NFRD and for financial market participants exposed to SFDR, we believe that ultimately, it will effectively support the transition to a lower carbon world, mobilizing the finance industry to redirect financial flows towards that purpose.

It should also make engagement a crucial tool to drive change and support companies' transition to support the SDGs.

Several challenges remain, including:

- "Taxonomy-like" developments overseas.
- The availability of ESG data supporting KPIs defined in the Taxonomy.
- Uncertainties on whether there will be enough available projects to match the demand.

Just as importantly, regulation provides significant opportunities for asset managers on the commercial front, supporting further development of funds dedicated to specific thematics including the circular economy, the preservation of biodiversity/ecosystems, and on the social front, an increasing focus on human capital and human rights.

Annex:

5 Summary tables of the Taxonomy

5.1 SUBSTANTIAL CONTRIBUTION TO CLIMATE CHANGE MITIGATION

A table is provided for economic activities that make a substantial contribution to climate change mitigation, which includes an indication of whether the technical screening criteria relate to the performance of the economic activity itself or whether the activity is an enabling activity. Economic activities that are considered transitional are indicated as such. This represents the TEG's best judgement but we note that this categorisation may be open to interpretation in some cases. There is also a table for activities that make a substantial contribution to climate change adaptation.

Technical screening criteria are provided for economic activities within the following sectors:

Classification		Environmental Contributions								
NACE Macro-sector	NACE Activity	1. Climate change mitigation (Substantial Contribution)			2. Climate change adaptation (DNSH)	3. Water (DNSH)	4. Circular economy (DNSH)	5. Pollution (DNSH)	6. Ecosystems (DNSH)
		Own performance	Enabling activities	Transitional activities					
	Afforestation	✓			✓	✓		✓	✓
	Rehabilitation, Reforestation	✓			✓	✓		✓	✓
	Reforestation	✓			✓	✓		✓	✓
	Existing forest management	✓			✓	✓		✓	✓
	Conservation forest	✓			✓	✓		✓	✓
	Growing of perennial crops	✓		✓	✓	✓	✓	✓	✓
	Growing of non-perennial crops	✓		✓	✓	✓	✓	✓	✓
	Livestock production	✓		✓	✓	✓	✓	✓	✓
	Manufacture of low carbon technologies		✓		✓	✓	✓	✓	✓
	Manufacture of Cement	✓		✓	✓	✓	✓	✓	✓
	Manufacture of Aluminium	✓		✓	✓	✓	✓	✓	✓
	Manufacture of Iron and Steel	✓		✓	✓	✓	✓	✓	✓
	Manufacture of Hydrogen	✓		✓	✓	✓	✓	✓	✓

Source: Taxonomy: final report of the Technical Expert Group on Sustainable Finance

3.4 Manufacture of Iron and Steel

Sector classification and activity	
Macro-Sector	C – Manufacturing
NACE Level	3 and 4
Code	C24.1: Manufacture of basic iron and steel and of ferro-alloys C24.2: Manufacture of tubes, pipes, hollow profiles and related fittings, of steel C24.3: Manufacture of other products of first processing of steel C24.5.1: Casting of iron C24.5.2: Casting of steel
Description	Manufacture of iron and steel
Mitigation criteria	
Principle	Manufacturing of iron and steel at the level of performance achieved by best performing plants is considered to make a substantial contribution to climate change mitigation. Furthermore, secondary production of steel (i.e. using scrap steel) is considered eligible due to significantly lower emissions than primary steel production. Mitigation measures are eligible provided they are incorporated into a single investment plan within a determined time frame (5 or 10 years) that outlines how each of the measures in combination with others will in combination enable the activity to meet the threshold defined below actions
Threshold	Manufacturing of iron and steel is eligible if the GHG emissions (calculated according to the methodology used for EU-ETS benchmarks) associated to the production processes are lower than the values of the related EU-ETS benchmarks. As of February 2020, the EU-ETS benchmarks values for iron and steel manufacturing are: • Hot metal = 1.328 tCO2e/t product • Sintered ore = 0.171 tCO2e/t product • Iron casting = 0.325 tCO2e/t product • Electric Arc Furnace (EAF) high alloy steel = 0.352 tCO2e/t product • Electric Arc Furnace (EAF) carbon steel = 0.283 tCO2e/t product • Coke (excluding lignite coke) = 0.286 tCO2e/t product All green new steel production, or combination of new and recycled steel production, is eligible if the emissions fall below the thresholds above.

Source: Taxonomy report: technical annex, March 2020