LSFI
Luxembourg
Sustainable Finance
Initiative

Series of webinars on the EU taxonomy

Discussion on future developments with the Platform on Sustainable Finance

Key Takeaways

Sustainable finance (SF) is rapidly evolving and becoming increasingly relevant. In this context, the need for regulation and standardisation at the European level has progressively gained importance. In July 2020, the EU Commission (EC) published the Taxonomy Regulation, setting out the conditions that an economic activity has to meet in order to qualify as environmentally sustainable. While the taxonomy is already in place, it is still a work in progress that needs further development. In this context, the EC established in September 2020 the Platform on Sustainable Finance to seek advice and recommendations in developing sustainable finance policies and notably to further develop the EU taxonomy.

On the 24th and 26th of February, the Platform on Sustainable Finance organised five webinars about their work on the EU Taxonomy. Through presentations, panel discussions, and Q&A sessions, these webinars posed an occasion to confirm the taxonomy's key objectives and discuss the latest developments in the matter, initial considerations, and future steps.

The pages below summarise some of the key takeaways from these five sessions aiming to provide the reader with an update and an explanation of the work carried out by the Sustainable Finance Platform and the EU taxonomy's status.

- **Session 1** focused on the role that the EU taxonomy can play in stimulating and mobilising finance to transition to environmental sustainability.
- **Session 2** discussed possible ways of extending the EU taxonomy framework beyond green activities.
- **Session 3** presented some of main challenges and possible solutions with regard to taxonomy-linked data, corporate reporting and disclosure.
- **Session 4** offered insights into the working process of the Platform with regard to developing the EU taxonomy criteria for the remaining four environmental objectives (water, circular economy, pollution and biodiversity).
- **Session 5** addressed the potential development of social taxonomy and give an insight into a possible structure of such taxonomy.

Session 1 - Enabling transition finance

This first session consisted of an introduction to the Taxonomy Regulation and its objectives, and a presentation of the Platform on Sustainable Finance and its role.

What is the EU Taxonomy?

The EU taxonomy is a tool meant to translate the long-term transition targets into concrete actions. It is a benchmark to define what is aligned with the Paris Agreement goals and to facilitate the transition of the economy towards them.

According to the panellists, the following pre-conditions for the taxonomy to work correctly and be a reliable tool are needed: it must be credible and science-based, while it also needs to be useful and not perceived as a burden. Furthermore, it should cover all the sectors, and not only the green ones, and therefore the need for developing it further.

Why an EU taxonomy?

Its key objectives are:

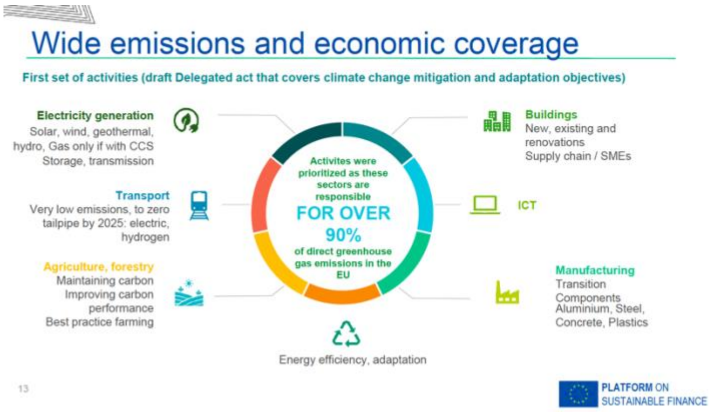
- Create an inventory for the future on what is sustainable.
- Set up a reporting enabler to measure the degree of the environmental fit and contribution of an investment product.
- Establish a transition tool to plan and report on the transition.
- Set out an EU legislation to guide the decisions.
- Make it based on evidence and science, as well as robust criteria.
- Be a dynamic tool that will be constantly updated and comprehensive to allow an inclusive transition.

In these lines, it is important to note that the taxonomy is not mandatory and that those activities which are not covered are not necessarily harmful ones.

What does the EU taxonomy cover?

1. All activities that contribute to one of the six environmental objectives.
2. Transitional activities, where no technical and economically feasible low-carbon alternatives are available, and that can still support the transition to a low-carbon economy.
3. Enabling activities.

In this respect, the taxonomy represents an opportunity to talk about the future, where the capital should be going in order to guide and get support from the financial markets for the future. While it still has to be further developed, it is worthy to note that it already includes the activities that are responsible of 90% of the emissions.



What is the EU Platform on Sustainable Finance and what are its main activities?

The EU Platform on Sustainable Finance was established in September 2020 by the EC with the mandate to advise the Commission on several topics related to develop the EU taxonomy further. For example, the technical screening criteria, the environmental objectives not yet covered, the review of the taxonomy regulation and its extension to social criteria and societal objectives. The Platform counts 57 members and 10 observers from different sectors, including industry, academia and civil society. It is structured in several working groups which can be found here.

During this first session, the panellist recalled some of the questions and matters that the EU Commission posed the Platform in the first place:

- How the taxonomy can support the full transition of the economy towards sustainable activities.
- How it can be used to support the work of the companies that do not meet the criteria yet.
- To work on the terminology to make sure there is coherence across all relevant frameworks on SF.
- How to address the concerns to the fact that the taxonomy could prevent effectively the transition.

What is the foreseen timeline and actions?

As anticipated by the panellists, the Platform's recommendations will be used to feed several of the EC's lines of work, such as:

- The 1st delegated act on climate objectives that the Commission intends to adopt by the second half of April 2021.
- The renewed sustainable finance strategy that the Commission aims to adopt in Q2 2021.
- The baseline for the social taxonomy with a report to be issued by Q3 2021.
- The 2nd delegated act that the Commission intends to adopt by the end of 2021.
- A strategic communication document to explain the importance of the taxonomy for the EU green deal.

Session 2 - Developing potential taxonomies beyond green activities

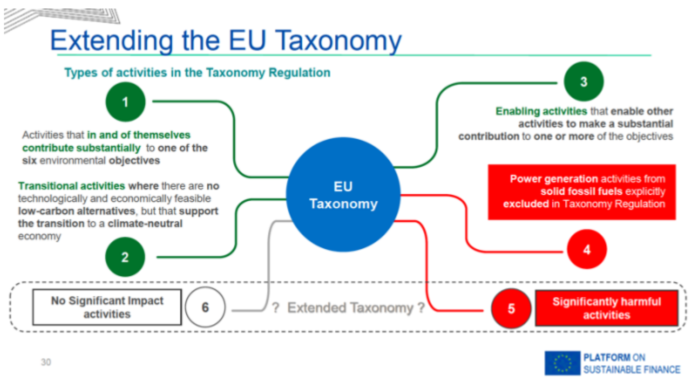
After introducing the taxonomy, the second session covered the possibility of the "Extension of the Taxonomy". The Sub-Group No.3 of the Platform is focused on this and has been mandated to:

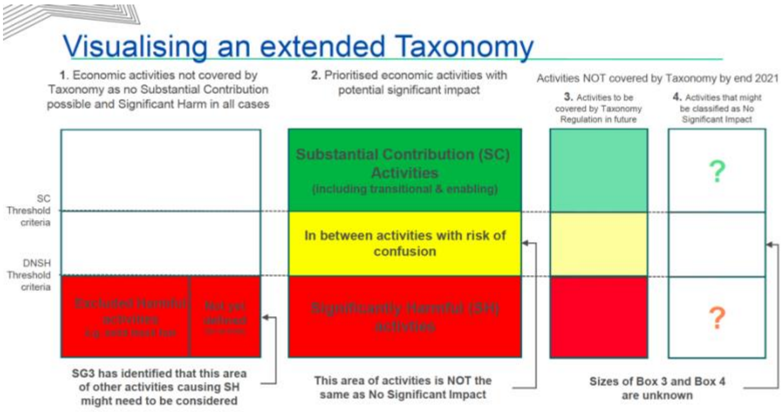
- Deliver a report assessing possible use cases for developing a taxonomy for economic activities that significantly harm (SH) and have no significant impact (NSI) on the environmental objectives;
- Provide recommendations on whether and how a taxonomy framework can and should be extended to cover such activities.

Extended taxonomy – focus of the working group

In particular, their focus of work is what to do for activities that are not in the taxonomy yet and will not be there because they significantly harm or because they do not provide a substantial contribution.

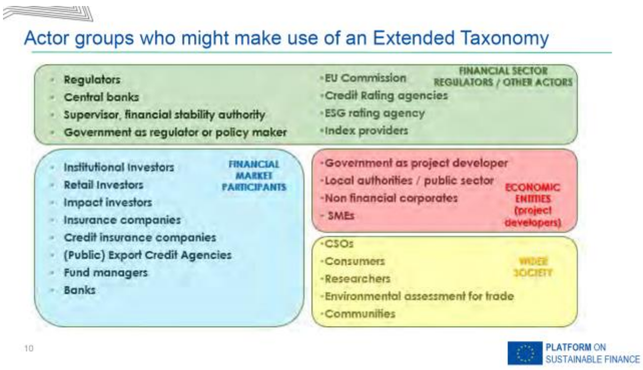
For these purposes, the working group (WG) is developing a potential framework to map these activities, as shown in the slide below.





More in detail, and as it was explained by the panellists, by the current definition there are activities that neither significantly harm, nor substantially contribute and which are excluded from the taxonomy framework. These also apply to some activities that might not be under the taxonomy because they do not yet exist. In this respect, it will be key to embed the dynamic element of the economy within the taxonomy. To achieve this, it is fundamental for it to be periodically revised. For example, it could be updated at least every three years in order to identify and cover all the latest technological updates.

In addition, the WG is developing use cases for actors that play a different role in the economy and that could benefit from the extended taxonomy. An example could be financial market participants interested in understanding better what is happening in their portfolio, companies that would like to transition, and or even the broader society that could use this information to model or take pension choices.



What are the risks and opportunities of an extended taxonomy?

The session also included a panel discussion where industry experts and members of the panel discussed whether an extended taxonomy is needed and what would be the benefits. The discussion and challenges with respect to usability and risks for the economies were highlighted, as well as the possible benefits when it comes to transition and comparability. The main topics which were pointed out were:

- The two major challenges are connected to usability and to the complexity behind the sectors and activities. In order, for example, to be a useful tool, it was mentioned that it would have to be dynamic and supported by clear and understandable reporting systems. It should also be science-based and very solid, not driven by opinion but by facts, as it is for the current taxonomy.
- Another of the risks could be over-regulation. In this respect, it was said that is important that activities that can transition are supported, but also to take into account those which will not be able to do so. Helping companies transition is critical. For example, Eastern and Central European Countries positions were presented to highlight the risks foreseen with the implementation of an extended taxonomy in the short-term.

- One possibility would be to start with the green taxonomy and wait for the adoption of the for Non-Financial Reporting Directive (NFRD) framework to support the availability of data from companies. The WG is still considering whether such a taxonomy should be developed and how. The expected timeline foreseen for the report that they have to perform is May 2021, which would be followed by public consultation over the summer to have the final report in September 2021.

Session 3 - Data and corporate reporting

This session provided an overview of the work conducted by the Subgroup No. 5 which focuses on data availability and usability. More in detail, the panel discussion ensured the audience that meaningful and user-friendly guidelines will be developed.

The working group (WG) is in charge of providing advice and consulting on data quality and availability, market preparedness, on the usability of the criteria and on the evaluation and development of sustainable finance policy issues, among other. More in detail, they are currently focusing on the following priorities:
- Make recommendations on what and how companies and financial undertakings should report on the taxonomy.
- Reach out to SMEs and start pilot projects.
- Continue the work on data.

Recommendations for companies – some questions and answers posed

- *Where to start for users for a practical application?*
  For the users, it is important to understand where revenues are generated and how those revenues relate to the taxonomy activities and, therefore which ones are eligible activities. Eligible activities will then have to reach an alignment to the taxonomy.

  In these lines, in March 2020, the TEG released a mapping tool with the full list of NACE industry activities that have a substantial contribution, this can allow to understand which companies might be eligible.

- *Can people rely only on NACE code to define an economic activity?*
  NACE is a great classification tool of economic activities, however, there is the need for a little bit more specifications in the coding for certain sectors. The WG will provide further clarification and guidelines to complete the NACE classification.

- *What are the key challenges of this mapping exercise?*
  The working group has looked in detail at companies in the various sectors to understand how revenues are reported. For example, the eligibility of "enabling" activity is being analysed by them to improve the usability of the taxonomy, in order to limit interpretation and provide a solid base to finance truly sustainable investment.

  A key matter here will be the transparency around the reporting: companies should become more transparent when it comes to sustainable activities. Once the activity complies with substantial contribution criteria, it has to be compliant with the do not significant harm criteria, and finally with the minimum social safeguards.

  More in detail, disclosure and granularity on OPEX and CAPEX will be key. CAPEX and OPEX can and will demonstrate the direction of a company towards a sustainable outcome. The taxonomy will enhance a more granular and detailed reporting on CAPEX to attract capital. The WG will work to identify the way to support companies that are willing to transition.

SMEs

As exposed by the speakers, Small and Medium Enterprises are a very heterogeneous group, with a short supply chain and they need financing for transition. Usually, these types of companies would need a lot of OPEX and less CAPEX. However, they do not have the capacity to collect all the information required by the taxonomy and they lack expertise and resources to do the analysis. Thus, it would be important to balance proportionality and relevance, eventually reshaping the OPEX dataset.

Additionally, SMEs' access to financing is provided through banks and these might seek to be aligned to the taxonomy. To ensure the financing from banks is not stopped, the panellists suggested to create a more enabling environment to have SMEs transition in a proportionate way. The WG is working on the direction of analysis and taking into account these challenges.

Data

With regard to data availability, according to the panellists, some of the data needed is already available. However, it has to be represented in the right format. The taxonomy will support the harmonisation and comparison of data. For example, an equivalence table is currently being developed to align NACE code to understand what companies might be taxonomy eligible.

Additionally, it was said that from the investor point of view, the taxonomy will allow investors to navigate their portfolios and it will become a common language that will provide the possibility to compare data. Investor needs standardised and easily accessible information. Of course, it will be key to identify data for companies not falling into the Non-Financial Reporting Directive (NFRD).

Session 4 - The process of developing taxonomy criteria for the remaining four environmental objectives

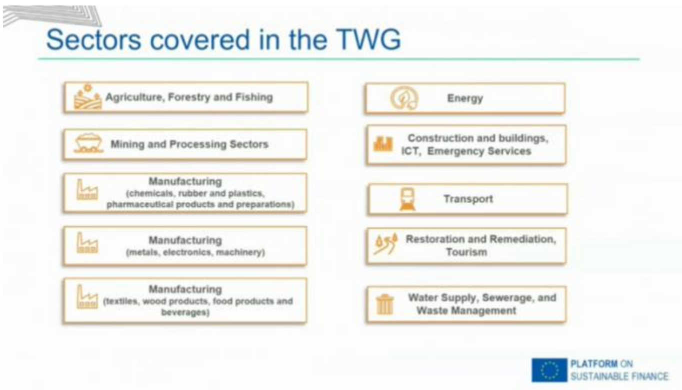
This session provided an update on the work done by Technical Working Group, which is in charge of developing the technical screening criteria and of defining the level of environmental ambition, also referred to as "the overall targets", for the four remaining environmental objectives, which are:
- Sustainable use and protection of water and marine resources.
- Transition to a circular economy.
- Pollution prevention and control.
- Protection and restoration of biodiversity and ecosystems.

The level of ambition refers to an overarching goal to be identified for each objective, as for example the one already specified for climate (e.g., being climate neutral by 2050).

The WG is also supposed to advise on possible updates to the existing criteria for the climate's objectives. Their recommendations will form the basis for the 2nd Delegated Act (DA), setting the conditions under which an activity is:
- Substantially contributing to one or more environmental objectives, and
- does not significant harm (DNSH) to the other objectives.

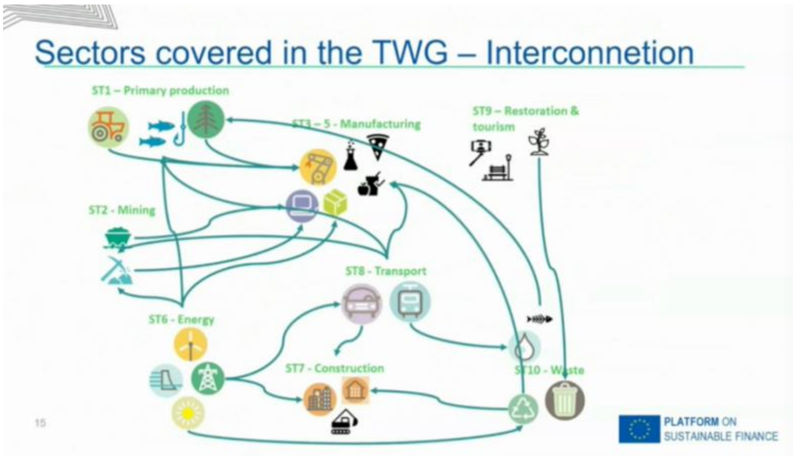
What is the current status of the work?

As of now, around 60 activities are being considered by the WG, which is divided into ten teams composed by a mix of industry representatives, NGOs, banks, academia, researchers and by appointed additional experts for a total of around 100 members. Each team covers prioritised sectors following the NACE codes for economic activities as shown in the picture.



In particular, within each sector team, experts have been identified for Water, Biodiversity, Circular Economy and Pollution – in order to have a horizontal WG working across the sectors' teams.

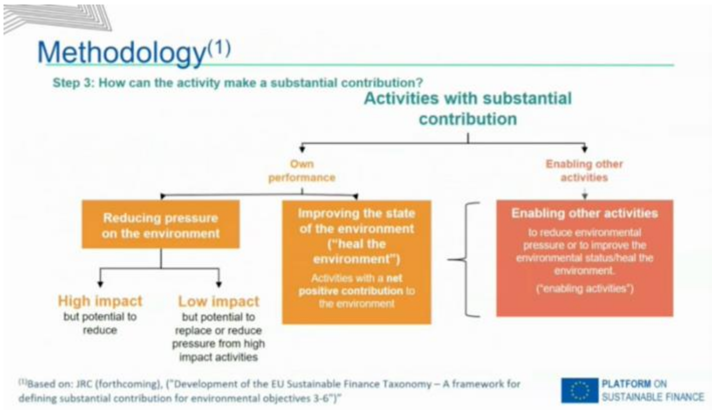
Not all four objectives will be covered by all the sectors' teams as some will be focusing only on meaningful objectives for the sector(s). The simplified slide below shows how the group sees the flow of materials and interconnections between sectors:



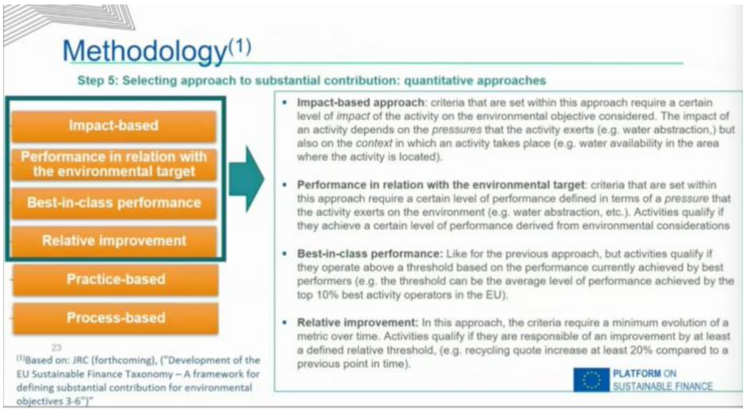
What is the methodology used by the working group?

The methodology used to develop the criteria was created by the European Commission's Joint Research Centre (JRC). Additionally, the WG started its work in December 2020 on a pre-prioritised list of activities developed by an external study. The definition of the activities' environmental impact to the objective follows these 8 steps and logic.

Steps to technical screening criteria
1. Describe nature of contribution
2. Define the scope of the activities
3. Define 'type of contribution'
4. Identify reference points
5. Select approach to criteria
6. Set level of ambition
7. Determine criteria for SC
8. Determine criteria for DNSH



Through the methodology, for each activity it is defined how a substantial contribution can be made to the environmental objective as well as the level of granularity. Afterwards, each team has to describe how reference points can be identified. Whenever feasible, approaches considered are quantitative, however qualitative approaches are considered when this is not possible (practice-based or process-based).



According to the panellists, technical screening criteria will ensure coherence with the policies, the environmental ambition and integrity, the level of playing field and the usability of the criteria.

Session 5 - Social taxonomy - how might it look like

The latest session summed up the work performed by the Subgroup No.4, which advises on the extension of the taxonomy to social objectives and on the functioning of the minimum safeguards described in art 18.

While the social taxonomy and the work of this group are still at an early stage, the panellists presented a first idea of how this could look. The first consideration is that social objectives are a key element of sustainable investing: socially inclusive measures need to accompany green transition, also a just transition needs to be set up.

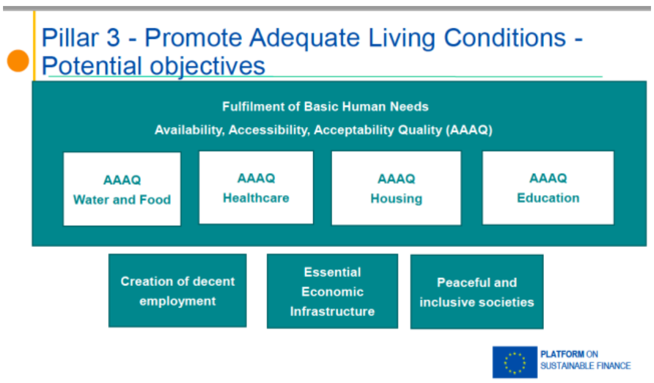
The foreseen structure will be based on 3 pillars. Two of these would focus on how business is done and on companies itself, while the third one would be linked to what kind of business it is referred to. This structure can be found below:

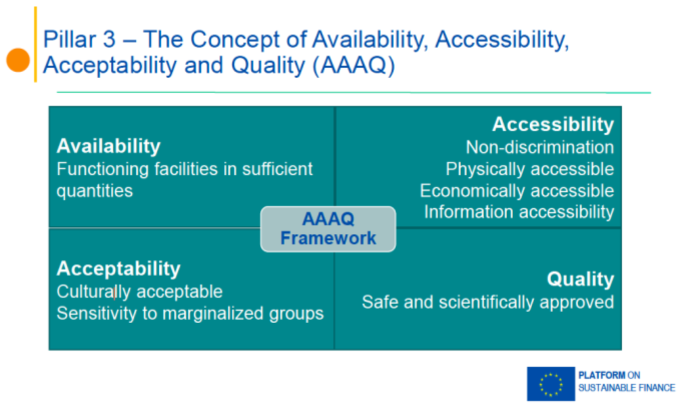
It was explained that each of the pillars will be developed around various objectives, each of them divided into sub-objectives / subtopics yet to be developed, to help identify whether a business is aligned with the social taxonomy. The WG is identifying the way to make sure the social taxonomy can be easily and effectively implemented.

More in detail, Pillar 1 is built around who is impacted by the business: workers, consumers and communities. For these purposes, the WG has also identified areas for which metrics are already present or will need to be developed. Here, respect for Human Rights is closely linked to the value chain of a company.

Pillar 2 would refer to Governance objectives. The WG is focused on verifying links and overlaps with other existing regulation, for example, governance is already included in the SFDR as well as in the NFRD. The objective is to make sure it will be aligned with what is already present and what is going to come.

Pillar 3 will be developed around the promotion of adequate living conditions, which is part of the Universal Declaration of Human Rights. In this context, the concept of AAAQ has been put in place to ensure that businesses are classified as social as far as they are Available, fully Accessible in all dimensions, Acceptable and Quality is granted. Further information can be found below:





The group is now developing a template for criteria to define the indicators that will have to be considered on the social side. However, according to the panellists, one of the main challenges is driven by the fact that social criteria cannot be based on science. Therefore, the foundations of the social taxonomy must be international norms and principles.

Disclaimer I The information presented in this document summarises the discussions and facts exposed during the “EU taxonomy Webinars - Discussion on future developments with the Platform on Sustainable finance”. They do not represent LSFI’s opinion or analysis. The images used to accompany the text, have been taken from the slides presented by the Platform on Sustainable Finance during the seminars and the full presentations can be found [here].

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