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UPDATE ON POLITICAL AGREEMENT ON THE EU TAXONOMY

The European Council and the European Parliament reached a political agreement on the Taxonomy Regulation on 18 December 2019. The Taxonomy Regulation will introduce a complex classification system of sustainable activities based on contributions to environmental objectives and technical criteria, as well as wider social and sustainability factors. It also recognises transition and enabling activities. The Taxonomy Regulation will not only apply to sustainable financial products, but also stipulates mandatory disclaimers for mainstream fund and pension products that are not using the Taxonomy as well as reporting requirements for large firms already subject to the Non-Financial Reporting Directive. These latter corporate level disclosures may however facilitate those required of financial intermediaries by the separate and earlier Disclosure Regulation. The Taxonomy Regulation will start applying from December 2021 and is likely a landmark regulation that requires the attention of all capital market participants and stakeholders in Europe and internationally.

Background

After the publication in March 2018 of its Action Plan on sustainable finance, the European Commission launched dual initiatives to develop an EU Taxonomy for sustainable activities. On the legislative front, this took the form of a proposal for a regulation on the establishment of a framework to facilitate sustainable investment (the "Taxonomy regulation). This regulation establishes the conditions and the framework to gradually create a unified classification system ('Taxonomy') on what can be considered an environmentally sustainable economic activity. In parallel, it tasked the Technical Working Group on Sustainable Finance (TEG) created in June 2018 to develop as a priority the technical details of the Taxonomy. ICMA, with the support of the GBP SBP Executive Committee, was nominated as a member of the TEG following a highly selective process.

The TEG report on the EU Taxonomy for sustainable activities published in July 2019 sets out the basis for a future EU Taxonomy and aims to help investors and other potential users to start to understand the implications of the Taxonomy. The report contains (i) technical screening criteria for 67 activities that can make a substantial contribution to climate change mitigation, (ii) a methodology and worked examples for evaluating substantial contribution to climate change adaptation and (iii) guidance and case studies for investors preparing to use the Taxonomy.

On 18 December 2019, the European Council and the European Parliament reached a political agreement on the Taxonomy regulation. This update note aims to summarise the content and implications of this agreement for financial market participants.

A Complex Classification Framework

The Taxonomy Regulation provides for a general framework that will allow for the progressive development of an EU-wide classification system for environmentally sustainable economic activities. This framework has however gained in complexity as it expanded to incorporate wide sustainability criteria and climate transition.

The Taxonomy Regulation sets out six environmental objectives (i) Climate Change Mitigation, (ii) Climate Change Adaptation, (iii) Sustainable Use and Protection of Water and Marine Resources, (iv) Transition to a Circular Economy, (v) Pollution Prevention and Control and (vi) Protection and Restoration of Biodiversity and Ecosystems. It also includes four requirements that economic activities need to comply with in order to qualify which are that (i) they provide a substantial contribution to at least one of the six environmental objectives above, (ii) "No significant harm" is caused to any of the other environmental objectives, (iii) compliance with robust and science-based technical screening criteria, and (iv) compliance with minimum social and governance safeguards.

The Taxonomy recognises further three different types of environmentally sustainable economic activities:

1. **Sustainable activities** that in and of themselves contribute substantially to one of the six environmental objectives.
2. **Transition activities** for which there are no technologically and economically feasible low-carbon alternatives, but that support the transition to a climate-neutral economy in a manner that is consistent with a pathway to limit the temperature increase to 1.5 degrees Celsius above pre-industrial levels, for example by phasing out greenhouse gas emissions.
3. **Enabling activities** that enable others to make a substantial contribution to one or more of the objectives, and where that activity does not lead to a lock-in of assets that undermine long-term environmental goals, and considering the economic lifetime of those assets has a substantial positive environmental impact on the basis of lifecycle considerations.

Nuclear energy is neither explicitly excluded nor included in the list of eligible environmentally sustainable economic activities. The importance of "climate-neutral energy" for the transition has been explicitly recognised in a recital. The decision to include or exclude nuclear energy has been left to the detailed rules based on technical expert input, subject to "do no significant harm criteria", in particular with regards to the disposal of waste, as well as specific references to life-cycle considerations. Gas is also neither included nor excluded from the EU taxonomy. It will be subject to a technical assessment for the development of the delegated legislation.

Finally, the Taxonomy Regulation creates a review clause which would allow the Commission to investigate extension of the Taxonomy to activities which cause significant harm to environmental objectives ("brown taxonomy").

A Mandatory Reference for Sustainable Financial Products

Once the Taxonomy Regulation is implemented, it will become a mandatory reference for sustainable financial products in Europe, and specifically:

- Funds and pension products as defined in the regulation[1] will need to disclose how and to what extent their underlying investments support economic activities that meet all the criteria for environmental sustainability under the Taxonomy Regulation.
- The Taxonomy Regulation will need to be used by Member States or the European Union when they say that public measures, standards or labels concerning financial products or corporate bonds offered by financial market participants or issuers are environmentally sustainable.
- Future European labelled sustainable financial products such as the European Green Bond Standard or the Ecolabel for Financial Products are respectively expected to be totally and partially aligned with the Taxonomy.

A Significant Extension of Sustainability Disclosure Requirements

The Taxonomy Regulation significantly expands the scope of sustainability disclosures as it will impact both mainstream funds and pension products and introduce new reporting requirements for large organisations:

- Mainstream funds and pension products that do not propose to specifically invest in sustainable activities will need to make an explicit statement that their investments do not take into account the Taxonomy Regulation.
- Financial and non-financial companies that fall under the scope of the Non-Financial Reporting Directive (NFRD) would have to disclose information on how and to what extent their activities are associated with environmentally sustainable economic activities. This refers to large public-interest companies with more than 500 employees, covering approximately 6,000 companies and groups across the EU.

These latter issuer level disclosures may facilitate those required of financial intermediaries by the separate and earlier Disclosure Regulation. This regulation lays down rules for financial market participants and financial advisers on transparency for the integration of sustainability risks and the consideration of adverse sustainability impacts in their processes, as well as the provision of sustainability-related information notably with respect to funds and pension products.

Implementation and Timelines

The Taxonomy will be developed through delegated acts and will be published in two sequences. Specifically:

- The delegated act on the first two climate-related objectives (i.e. “Climate Change Mitigation” and “Climate Change Adaptation”) should be adopted by the Commission by 31 December 2020 and will therefore start applying as of 31 December 2021.

[1] These funds and pension products are referred to as “financial products” and are defined as: (a) a portfolio managed in accordance with mandates given by clients on a discretionary client-by-client basis where such portfolios include one or more financial instruments (b) an alternative investment fund (AIF); (c) an IBIP; (d) a pension product; (e) a pension scheme; (f) a UCITS; or (g) a PEPP.

- The delegated act on the remaining four environmental objectives should be adopted by the Commission by 31 December 2021 and will therefore start applying as of 31 December 2022.

Further Development of Technical Criteria

The TEG recommendations are the first input to the Commission's work on developing the future delegated acts. The TEG will finalise its recommendations by February 2020.

A Platform for Sustainable Finance gathering various experts and stakeholders will be created to assist the Commission in the development of these delegated acts. It will be tasked with providing advice on the technical screening criteria and a number of other relevant topics. The Commission will also be advised by a Member State Expert Group to ensure the suitability and usability of the criteria.

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