

THE EUROPEAN UNION SUSTAINABLE FINANCE TAXONOMY: Implications for Canada

MAY 2020

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The European Union Sustainable Finance Taxonomy has arrived! What is it, and why should Canada care?

The European Union (EU) Sustainable Finance Taxonomy is a game-changer. It is the first comprehensive, science-based classification system creating a common language for sustainable investments. Canadian companies, institutional investors and governments should consider adopting the EU Taxonomy in an effort to attract the vast amounts of capital required to convert our high-carbon economy into a low-carbon economy and to meet our commitments under the Paris Agreement. This paper provides a brief overview of the EU Taxonomy and rationale for why Canada should embrace it.

THE EUROPEAN GREEN DEAL

The EU is profoundly serious about climate change and sustainability. On December 11, 2019, Ursula von der Leyen, the European Commission president and former German defence minister, announced the ‘European Green Deal’, describing it as “Europe’s man on the moon moment.” It offers an overarching framework and program of actions designed to make the EU’s economy sustainable and aims to achieve a “climate neutral economy by 2050”. Ms. von der Leyen described the European climate policy as “Europe’s new growth strategy”. With climate change top of mind, the European Commission is proposing to transform these political promises into binding legal obligations. On March 4, 2020, it unveiled its ‘European Climate Law’ — a vital component of the European Green Deal — that will bind EU institutions and the governments of EU Member States to target climate neutrality by 2050, per the Paris Agreement. This new law still needs approval from the European Parliament and the EU Member States.

THE EU ACTION PLAN ON SUSTAINABLE GROWTH

In March 2018, the European Commission adopted an action plan on sustainable finance as part of its strategy to integrate environmental, social and governance principles into its financial policy framework and to mobilize funding for sustainable growth. This EU Action Plan on Sustainable Growth called for the creation of a classification system for sustainable economic activities: the **Taxonomy**. In May 2018, the European Commission proposed **Taxonomy Regulation** creating a legal framework and environmental objectives for the Taxonomy and new legal obligations for financial market participants, large companies, the EU and the EU Member States. The Taxonomy Regulation was agreed to at the political level in December 2019.

THE TECHNICAL EXPERT GROUP

The European Commission also established the Technical Expert Group on Sustainable Finance (TEG). TEG is mandated to develop recommendations for technical screening criteria for economic activities that contribute substantially to **climate change mitigation**¹ and **climate change adaptation**² while, at the same time, not harming four other EU environmental policy objectives, intended to achieve:

- Sustainable use and protection of water and marine resources,
- Transition to a circular economy,
- Pollution prevention and control, and
- Protection and restoration of biodiversity and ecosystems.

For every environmental objective, the Taxonomy Regulation recognizes two distinct types of substantial contribution that can be considered taxonomy-aligned:

- economic activities that make a substantial contribution based on their own performance (for example, an economic activity performed in an environmentally sustainable way), and
- economic activities that enable a substantial contribution to other activities by providing products and services (for example, an economic activity that manufactures a component that improves the environmental performance of another activity).

TEG is comprised of 35 experts from the financial services industry, NGOs and the scientific community. Considering the complexity and magnitude of the project, TEG invited an additional 160 experts to assist in developing the Taxonomy.

TEG started its work in June 2018 and released its first draft proposal for the Taxonomy in December 2018. In June

2019, it released a technical report containing proposed technical screening criteria for substantial contributions to climate change mitigation across 67 economic activities. This report also outlined the conceptual approach for climate change adaptation and initial guidance on how to use the Taxonomy. On March 9, 2020, TEG released a report setting out its final recommendation to the European Commission. It includes three reports:

- **Summary report** that describes the key concepts and important design decisions,
- **Technical annex** that describes the detailed methodologies, criteria and rationale, and
- **Taxonomy spreadsheet** that summarizes all criteria, including tables for economic classification systems.

THE TAXONOMY

Addressing climate change requires large amounts of capital to flow towards economic activities that contribute significantly to climate change mitigation and adaptation. Although there are many investors interested in investing vast amounts of capital in projects related to both, it so far has been unclear which economic activities make significant contributions to these. In this regard, the EU Taxonomy will be a significant catalyst offering a science and evidence-based classification system for economic activities that meet the EU's environmental objectives, including both climate change mitigation and adaptation. It is a tool that helps investors understand whether an economic activity is environmentally sustainable and creates a common language for investors, issuers, project promoters and policymakers.

The **technical annex** of the final TEG report, released on March 9, 2020, contains detailed technical screening criteria for climate change mitigation and adaptation only. Detailed technical screening criteria for the other four environmental objectives still need to be developed. The technical annex uses the NACE classification system³ and covers industry sectors as noted below:

¹ Climate change mitigation: efforts to reduce/prevent green house gas emissions using new technologies and renewable energies, making older equipment more efficient, changing management practices or consumer behaviour, etc

² Climate Change adaptation: anticipating adverse effects of climate change/taking steps to minimize damage

Industry	Change Mitigation	Change Adaptation
Forestry	✓	✓
Agriculture	✓	✓
Manufacturing	✓	✓
Electricity, gas, steam, air conditioning & supply	✓	✓
Water sewage, waste and remediation	✓	✓
Transportation and storage	✓	✓
Information and communication	✓	
Construction and real estate	✓	✓
Financial and Insurance activities		✓
Professional, scientific and technical activities		✓

TEG has developed detailed screening criteria. For example, the technical annex includes sustainability criteria for “passenger cars and light commercial vehicles.” The annex uses CO2 emissions per kilometre travelled by a vehicle (g CO2/km) as the relevant sustainability metric. Vehicles with 0 “tailpipe” emissions (e.g., hydrogen, fuel cell, and electric-powered vehicles) are automatically taxonomy-eligible. Vehicles with a maximum tailpipe emission intensity of 50 g CO2/km are also taxonomy-eligible, but only until 2025. From 2026 onwards, only vehicles with a tailpipe emission intensity of 0 g CO2/km will be eligible. To avoid doing significant harm to any of the other environmental objectives, manufacturing plants should manage physical risks on a best-efforts basis, avoid undermining climate adaptation efforts by others, and ensure compliance with existing EU regulations on hazardous waste and end-of-life treatment of vehicles and pollution.

The economic activities covered by the EU Taxonomy are not exhaustive. Additional ones can and will be added to it in the future. Although TEG’s mandate was extended until September 2020, it will not be adding any economic activities. Instead, it will operate in an advisory capacity until the new ‘Platform on Sustainable Finance’—a permanent body established under the Taxonomy Regulation—is operational. The Platform on Sustainable Finance will be responsible for modifying the EU Taxonomy in the future. This will include adding new economic activities, removing outdated ones and modifying technical screening criteria.

BEING ENVIRONMENTALLY SUSTAINABLE

Just meeting TEG’s technical screening criteria is not sufficient to qualify as environmentally sustainable or “green” under the EU Taxonomy. An economic activity qualifies as such if it:

³ The EU’s Nace (Nomenclature des Activités Economiques dans la Communauté Européenne) industry classification system and the TEG have set technical screening criteria for economic within priosectors. This classification system was selected for its compatibility with EU Member State and international statistical frameworks and for its broad coverage of the economy.

- substantially contributes to one of the EU’s environmental objectives, which means that the economic activity meets its relevant technical screening criteria,
- avoids doing significant harm to any of the other environmental objectives, and
- meets certain minimum social safeguards, including the OECD Guidelines for Multinational Enterprises, the UN Guiding Principles on Business and Human Rights, and the ILO Core Labour Conventions.

Some economic activities will already meet the technical screening criteria. For economic activities that do not meet this criteria, TEG recommends that the financing of improvement measures (capital expenditures and operating expenditures) can be counted as taxonomy-aligned if they are part of an implementation plan to meet the activity’s technical screening criteria over a defined period. TEG recommends a limit of five years for these plans.

In other words, the Taxonomy is also somewhat of a sustainability transition tool.⁴

It assists with planning and with reporting the transition to an economy that is consistent with the EU’s environmental objectives. The Taxonomy disclosure obligations encourage the reporting of progress towards meeting and achieving the screening criteria. The Taxonomy provides tools for financing the transition of economic activities towards clear environmental goals. These include:

- technical screening criteria that are currently high but will ratchet down over time,
- recognition of capital and operational expenditures that contribute to meeting the technical screening criteria over time, and
- inclusion of improvement measures to reduce emissions and improve energy efficiency where the best available technologies and practices are used today.

In the future, financing and investments that are marketed as financing the transition to climate mitigation objectives will need to be explained in terms of the Taxonomy criteria. Disclosures in this area will help the market determine whether the environmental performance of an underlying economic activity is making a substantial contribution to climate mitigation objectives. Transition financing that does not meet the technical screening criteria may still reduce harm to environmental objectives but would not be considered sustainable.

Arguably, the currently recommended Taxonomy is both a “green” taxonomy and a “transition” taxonomy. What the recommended Taxonomy does not do, however, is define the criteria for a “brown” taxonomy—criteria for economic activities with significantly harmful emission levels expected to continue to be too high throughout the economic transition period. Developing criteria for significantly harmful emission levels will help investors, companies, issuers and project promoters understand the necessary speed and depth of the transition task ahead. The European Commission has decided to ask the Platform on Sustainable Finance to consider the development of a “brown” taxonomy—criteria for activities that are significantly environmentally harmful.

WHO SHOULD DISCLOSE WHAT, WHEN, WHERE AND HOW?

The Taxonomy is currently only a recommendation from TEG to the European Commission which will now develop “delegated acts” (legally binding obligations) to further implement elements of the Taxonomy Regulation, including the Taxonomy’s technical screening criteria for the EU’s environmental objectives. The technical screening

⁴ “Transition” is very narrowly defined in the Taxonomy Regulation: Article 6(1a) “...an economic activity for which there is no technologically and economically feasible low carbon alternative, shall be considered to contribute substantially to climate change mitigation as it supports the transition to a climate-neutral economy consistent with a pathway to limit the temperature increase to 1.5 degrees Celsius above pre-industrial levels including by phasing out greenhouse gas emissions, in particular from solid fossil fuels, where that activity:

- Has greenhouse gas emission levels that correspond to the best performance in the sector or industry,
- Does not hamper the development and deployment of low-carbon alternatives; and
- Does not lead to a lock-in in carbon-intensive assets considering the economic lifetime of those assets.

criteria for activities substantially contributing to climate change mitigation and adaptation will be adopted by the end of 2020 and will enter into force by the end of 2021. The technical screening criteria for economic activities which contribute substantially to the other four EU environmental objectives will be adopted by the end of 2021 and will enter into force by the end of 2022. The European Commission will also adopt a delegated act by June 1, 2021, implementing how the corporate disclosure obligations should be applied in practice. Non-financial and financial companies will have different disclosure obligations. Financial market participants offering financial products in Europe will have to incorporate disclosures aligned with the Taxonomy. The disclosure requirements will vary depending on product categories and have been aligned with the definitions in the EU Regulation on Sustainability-Related Disclosures in the Financial Services Sector. Companies subject to disclosure requirements under the Non-Financial Reporting Directive also must make disclosures aligned with the Taxonomy.

The Taxonomy Regulation identifies three groups of users of the Taxonomy:

- financial market participants that offer financial products in the EU,
- large companies that are required to provide a non-financial statement under the EU Non-Financial Reporting Directive, and
- EU and EU member states, when creating public measures, standards or labels for green financial products, including green bonds.

Financial market participants, institutional investors, including pension funds and fund managers, will have to make their first set of disclosures against the Taxonomy by December 31, 2021. This first set of disclosures only covers activities that substantially contribute to climate change mitigation and adaptation. By December 31, 2022, financial market participants will have to make their disclosures about all the EU's environmental objectives. These disclosures must be made in periodic reports, pre-contractual disclosures and on websites. Large companies, including publicly listed companies, banks and insurance companies, must make their first climate change mitigation and adaptation disclosures covering their 2021

financial year in 2022. In 2023, companies will have to make their disclosures about all the EU's environmental objectives covering their 2022 financial year. This disclosure timeline presents some implementation challenges, as corporate disclosures may not be available for financial market participants to use in their 2021 disclosures.

Large companies subject to the EU Taxonomy Regulation disclosure requirements will have to include a description of how, and to what extent, their activities are associated with Taxonomy-aligned activities.

For non-financial companies, the disclosure must include:

- the proportion of turnover aligned with the Taxonomy,
- capital expenditures and, if relevant, operational expenditures aligned with the Taxonomy.

By disclosing its turnover, a company provides investors with a clear picture of which of its economic activities are already aligned with the Taxonomy. It allows investors to report the percentage of its fund that is invested in Taxonomy-aligned activities. On the other hand, disclosing capital expenditures provides investors with the information required to assess the credibility of a company's intention to align its economic activities with the Taxonomy. Companies that disclose their capital investments in economic activities as part of a transition plan to be Taxonomy-aligned, provide critical information for analyzing their environmental sustainability strategies and for constructing "green" investment portfolios. Although not required by the Taxonomy Regulation, to provide transparency around which environmental objectives are being pursued, companies should complete their Taxonomy disclosures separately for climate change mitigation and adaptation for 2021 and all six EU environmental objectives from 2022 onwards. Also, companies should consider disclosing the proportion of Taxonomy activities that are categorized as "transition" or "enabling" activities, because investors are expected to disclose this breakdown in their disclosures.

The EU Taxonomy Regulation requires large companies to provide disclosures at the company level. These company level disclosures need to be built up from the economic

activity level of the company. Large companies must make their disclosures as part of their non-financial statements, which may be in their annual reports or dedicated sustainability reports.

As mentioned earlier, financial market participants offering financial products in the EU are required to make Taxonomy disclosures. Making Taxonomy disclosures is mandatory for certain types of products or offerings, and on a comply-or-explain basis for all other products and offerings. For each relevant product or offering, the financial market participant will need to state:

- how and to what extent they have used the Taxonomy in determining the sustainability of the underlying investments,
- to what environmental objectives the investments contribute, and
- the proportion of underlying investments that are Taxonomy-aligned, expressed as a percentage of the investment, fund or portfolio; this disclosure should differentiate between proportions of “enabling” and “transition” activities.

Disclosure against the Taxonomy is part of a broader mandatory sustainability disclosure regime for financial market participants. These broader disclosure obligations are included in the EU Regulation on Sustainability-Related Disclosures in the Financial Services Sector (SDR). These SDR obligations include pre-contractual, website and periodic reporting obligations.

NO FORMAL VERIFICATION REQUIRED

Currently, the Taxonomy Regulation does not require any formal verification of Taxonomy-related disclosures. However, TEG considers it good practise for issuers to seek external assurance on these disclosures. This is consistent with the recommended approach in the Taskforce on Climate-Related Financial Disclosures framework. The European Commission will, in 2022, review whether a formal verification will be required in the future.

SO WHY SHOULD CANADA CARE?

The Taxonomy Regulation only requires financial market participants offering financial products in the EU and large companies covered under the EU Non-Financial Reporting Directive to report against the EU Taxonomy. Given this, it might be asked why Canadian institutional investors, Canadian companies, Canadian banks and Canadian governments should care about the EU Taxonomy. Here are some reasons why:

- Canadian companies attract capital from European institutional investors. If a Canadian company does not disclose against the EU Taxonomy, to meet its requirements, the European investor will have to assess to what extent that company’s activities are EU Taxonomy aligned. This would render the potential investment more burdensome to evaluate and the investor may be much less likely to invest.
- EU Green Bonds and Green Loans can be an attractive source of funding for Canadian companies investing in, for example, carbon emission reduction projects. To qualify for EU green bonds and loans, Canadian companies must use the bond or loan proceeds for Taxonomy-aligned projects on a pre-contractual basis as well as during the term of the bond or loan. This means that Canadian companies need to be able to report in compliance with the EU Taxonomy.
- The EU Taxonomy is a science and evidence-based classification system that promotes the growth and standardization of sustainability. It has the potential to become a global sustainability standard that may also be adopted by non-EU institutional investors, which would make it even more important for Canadian companies to have the capabilities to report against the EU Taxonomy. For example, MSCI has already launched two “provisional” EU Taxonomy-based indices based on TEG’s final report: the MSCI Provisional EU Climate Change Transition Index and the MSCI Provisional EU Paris-Aligned Index.
- Canadian institutional investors may want to offer sustainable investment products to their investors. They can use EU Taxonomy-aligned sustainability standards to provide their investors with the confidence that their investments are truly supporting sustainability as opposed to “greenwashing.”
- Banks can incorporate EU Taxonomy-aligned sustainability standards, as part of their lending underwriting criteria, to provide greenhouse gas reduction incentives in the form of, for example, interest rate benefits.

As mentioned, the EU Taxonomy Regulation also identifies the EU and EU Member States as users of the Taxonomy. The Canadian federal, provincial, territorial and municipal governments can also adopt the EU Taxonomy as a basis for deciding which sustainability and climate change initiatives should be supported to achieve Canada’s net-zero 2050 greenhouse gas emissions commitment under the Paris Agreement. To achieve this, Canadian governments will need to introduce incentives. Examples might include subsidies, tax credits, guarantees and loans. To ensure that these measures are effective in achieving this objective, Canada needs a comprehensive set of science and evidence-based metrics. These metrics are not yet developed, and Canada needs to take urgent steps to meet its Paris Agreement commitments on time. The EU Taxonomy would be a great starting point for developing a climate change incentive program as suggested by the Expert Panel on Sustainable Finance.

Many Canadians within our business, government and academic communities view the EU Taxonomy as incomplete for a high-carbon natural resource-based economy such as Canada’s. Generally, the complaint is that the EU Taxonomy provides insufficient support for business activities that facilitate the transition from a high-carbon to a low-carbon economy. Mark Carney, former Governor of the Bank of England, previously, Governor of the Bank of Canada, and now Special Envoy to the UN

on Climate Change, has expressed concerns about the EU Taxonomy. On March 25, 2020 – in response to the EU Taxonomy, and speaking before the UK’s House of Lords EU financial affairs sub-committee, he said “If we are concerned about this whole economy transition and we are concerned about mainstreaming sustainable finance then you need that whole transition bucket in the middle rather than just “green” and “brown” finance.”⁵ Currently, the Canadian Standards Association (CSA) is leading an initiative to develop a Canadian Transition Taxonomy. This would provide a voluntary classification tool for transition-based financial instruments, including bonds and loans. It is intended to be complementary to the EU Taxonomy and is focussed solely on the reduction of greenhouse gas emissions as opposed to the EU’s multiple sustainability objectives. The CSA’s Canadian Transition Taxonomy is expected to be released towards the end of June 2020. For Canada – and other important natural resource-based economies such as Australia, China, the US and Japan – a transition-focussed taxonomy is critically important, and the CSA-led initiative can make a major contribution. Meanwhile, Canadian companies, institutional investors, banks and governments should consider how the EU Taxonomy can assist in attracting Canadian and global capital towards Canada’s transition from a high-carbon to a low-carbon economy.

⁵ Source: Environmental Finance

IN A NUTSHELL

The EU Taxonomy is genuinely a game-changer. One of the critical catalysts for kick-starting the sustainable finance industry that was missing was a comprehensive, science-based classification system creating a common language for sustainable investments. The EU Taxonomy is filling that critical void, and the EU should be commended for that. Canada – and the rest of the world for that matter – could decide to develop its sustainable finance taxonomy. However, considering the urgency of dealing with climate change and transitioning to a low-carbon economy, Canada would benefit from adopting the EU Taxonomy and supplementing it with a made-in-Canada transition taxonomy to address the unique transition challenges of our economy. This approach would also contribute to the development of a much-needed global sustainable finance taxonomy, especially if the rest of the world can be convinced to take the same path.

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