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COMPLIANCE AND SUSTAINABILITY

BRAZILIAN AND PORTUGUESE PERSPECTIVES

ORGANISERS
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2020

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II

SPECIAL PART

STRATEGIES AND PUBLIC AND PRIVATE COMPLIANCE INSTRUMENTS

3.

THE SUSTAINABILITY TAXONOMY OF THE EUROPEAN UNION

ON THE WAY TO THE OASIS OF RESPONSIBLE INVESTMENT

MARIA JOÃO PAIXÃO

Abstract: The environmental issue is now, perhaps more than ever, at the heart of the international legal and political debate. In the new century, governments around the world have made efforts to follow a more sustainable path for the planet, by adhering to international instruments such as the Paris Agreement and the United Nations 2030 Agenda for Sustainable Development. In this context, the European Union has been deepening its involvement in the environmental field. Recognising the absolute need for investment in the field of sustainability, without which the targets set are unlikely to be achieved, the European Commission presented, in 2018, an Action Plan for Sustainable Finance. The implementation of the Plan involves, first of all, the creation of a taxonomy for sustainable activities. The establishment of this taxonomy will provide the certainty and security essential for the successful implementation of other actions and European policies, thus assuming itself as a core element of the process of converting the current financial system into a stable and sustainable system.

Keywords: sustainability; taxonomy; responsible investment.

1. **Financial system and sustainability**

1.1. ***Climate change: the ignored threat to the financial sector***

Climate change is currently a *hot topic* internationally. Concerns about climate change have been growing exponentially, accompanying the increase in technical and scientific knowledge about the matter and the worsening of anthropogenic environmental consequences, which are currently more notorious than ever. In this context, a global movement supporting environmental, economic and social sustainability has grown, above all through the impulses of the "*millennial* generation".

More recently, the environmental issue has begun to receive attention in the financial sector. Studies and analyses on the subject have shown that the environment and the financial sector are related in a circular process: environmental sustainability can be achieved only with the contribution and commitment of the financial sector, and financial stability can be only achieved in the context of environmentally sustainable growth. On the one hand, the direction of capital for environmentally sustainable activities will be central to the process of climate change mitigation and the protection of biodiversity and ecosystems. On the other hand, environmental risks have strong macroeconomic and financial impacts, so the resolution or mitigation of major climate problems will be indispensable for economic and financial stability. It is therefore understandable why the High-Level Expert Group on Sustainable Finance nominated by the European Union established, in its Final Report, two urgent imperatives: to improve the contribution of finance to sustainable and inclusive growth and to enhance financial stability by incorporating environmental, social and governance factors into the investment decision-making process — the symbiosis is evident.

The reach of the climatic and energetic targets set at the international level depends on a strong investment, which, by its size, cannot come from, even for the most part, the states' budgets or from international or supranational organizations. In the European Union area alone, there is an estimated annual investment gap of almost 180 billion euros — without the investment deficit being close, the European Union will not be able to meet the objectives it has set until 2030. It should be noted that the non-achievement of the targets defined will mean a considerable increase in the probability of revision of the targets, with unpredictable and potentially catastrophic consequences, or in the probability of the occurrence of an abrupt transition to a sustainable and low-carbon economy, with serious losses, particularly economic and financial, for the actors involved[1]. In fact, the International Energy Agency estimates that the "carbon budget" (amount of greenhouse gases present in the atmosphere compatible with the objective of maintaining global warming below 2° C) will be exhausted around 2040, so after that date, the emissions would have to be below zero.[2]

In the exposed terms, environmental and climatic risks, although not properly considered until now, have had increasingly profound impacts on the financial sector. First, the upsurge in natural disasters implies increased costs for insurance companies. In addition, banks will also be exposed to greater losses due to the lower profitability of companies dependent on fossil fuels or scarce resources or exposed to abnormal meteorological events. Investors, in turn, see the predictability and security of the markets affected by the

[1] EUROPEAN SISTEMIC RISK BOARD, "Too late, too sudden: Transition to a low-carbon economy and systemic risk", *Reports of the Advisory Scientific Committee* 6 (2016).

[2] EUROPEAN SISTEMIC RISK BOARD, "Too late, too sudden".

vulnerability of business models to environmental issues and by the uncertain impact of regulatory policies on economic activities. It should be noted that close to half of the risk exposure of euro-area banks is directly or indirectly linked to environmental risks[3]. Among the top ten global risks, environmental risks are predominant, therefore assuming the position of the greatest threats to the real macroeconomic context[4]. In another perspective, sustainable investment can constitute, by itself, a smart investment since the association of assets with positive environmental factors can mean value creation. In fact, a positive correlation between the consideration of environmental, social and governance factors and the financial performance of companies has been proven, with the correlative valuation of the respective assets — and the growth of this trend is predictable[5].

1.2. ***Responsible investment and financial sustainability***

Considering the framework presented, the urgency of a greater (effective) interconnection between the financial sector and the environmental, governance and social factors is clear. It is exactly this affinity that underlies the concept of "*sustainable (or responsible) investment*": a process whereby environmental, social and governance considerations[6] are integrated into the

[3] Stefano Battinson *et al.,* "A climate stress-test of the financial system". *Nature Climate Change* 7/4 (2017) 283—288.

[4] world economic forum, *The Global Risks Report 2018*, Génova.

[5] Gunnar Friede / Timo Busch / Alexander Bassen, "esg and financial performance: aggregated evidence from more than 2000 empirical studies, *Journal of Sustainable Finance & Investment* 5/4 (2015) 210-233.

[6] More information on environmental, social and governance factors ("ESG factors") can be found on the institutional website of the "Responsible Investment Principles", a joint initiative of a group of investors and the UN Environmental Programme: <https://www.unpri.org/>.

decision-making of investment, leading to greater investment in sustainable and long-term activities. Sustainable investment will be absolutely cardinal for achieving the desired economic objectives, social inclusion and environmental regeneration. Only by including environmental, social and governance dimensions in market practices, investment decisions, production processes and regulatory frameworks will it be possible, on the one hand, to close the funding gap in sustainable development (indispensable for an effective and timely approach to the environmental issue) and, on the other hand, to protect the financial system from the impacts of climate change and the forced regulatory changes implemented to address this phenomenon. Moreover, this is the path that will make it possible to build a strong and solid financial system in the long term, so it is imperative to deconstruct the (wrong) idea that responsible investment is less profitable.

Considering the urgency and desirability of the transition to a low-carbon, circular and efficient economy, the European Union has been engaged in the construction of the "*most* sustainable financial system in the world"[7].

2. **European Union Action Plan: Financing Sustainable Growth**

2.1. ***Framing***

The centrality of environmental concerns in the current international debate is illustrated by the adoption, between 2015 and 2016, of the Paris Agreement on Climate Change and the United Nations (UN) Agenda 2030 for Sustainable Development, articulated around 17 sustainable development

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[7] EUROPEAN COMMISSION, *Final Report 2018 by the High-Level Expert Group on Sustainable Finance*.

goals. Through these instruments, governments from all over the world have committed themselves to sustainable practices for the planet and the economy, binding themselves to the implementation of the necessary efforts to create a new global model.

In the community area, sustainability has long played a preponderant role in the European Union project, being recognized by the Treaties in its economic, social and environmental aspects[8]. In the framework of international obligations on the matter, especially the limitation of global warming to a value below 2° C, the transition to a circular, low-carbon and efficient economy has become an imperative for the Community. Recognizing the key role to be played by the financial system in this area, at the end of 2016, the Commission appointed a High-Level Expert Group on Sustainable Finance that is responsible for drafting the intervention plan in the financial system with the objective of (re)targeting the system for sustainability. On 31 January 2018, the Expert Group published its Final Report[9], which stipulates the two guiding purposes of the strategy: 1) to increase the contribution of finance to sustainable and inclusive growth and 2) to strengthen financial stability by incorporating environmental, social and governance factors into the investment decision-making process. Based on the recommendations made in the report, the European Commission drafted and presented an Action Plan for sustainable finance in March 2018.

2.2. ***Guidelines and Actions***

The European Commission established the following cardinal objectives of its Action Plan:

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[8] *Vide*, in particular, the arts. 3º/3 and 5 and 21º/2/D) and F) of the Treaty on European Union

[9] EUROPEAN COMMISION — *Final Report 2018 by the High-Level Expert Group on Sustainable Finance*.

– Reorient capital flows towards sustainable investment;
– Manage financial risks stemming from climate change, resource depletion, environmental degradation and social issues;
– Foster transparency and long-termism in financial and economic activity.

First, the Action Plan is intended as an instrument to assist in addressing the annual investment deficit that is necessary for the transition to a circular, low-carbon and resilient economy. It is recognized that the value of 180 billion euros required for the achievement of the European Union's climatic and energetic objectives by 2030[10] cannot be provided, exclusively or in the majority, by the public sector. The EU has pledged to apply at least 20% of its budget to measures directly relevant to the climate, and most of the states are equally committed to building a more environmentally friendly system. However, the (un)success of the restructuring of the system will depend on the private investment obtained in this context — hence the need for measures to achieve capital redirection.

Second, the Commission intends to ensure, along with environmental protection, the stability of the financial system. Today, it is recognized that climate-related phenomena are *also* risks for the economy and for the financial system — investigations and research on the issue are increasingly incisive. Thus, the post-financial crisis reform of the system must integrate environmental, social and governance factors into the processes and market dynamics.

Third, the Action Plan also has a governance dimension. It is understood that the activity of participants in the market should be transparent and based on a long-term vision under

[10] Among which we highlight the significant reduction of greenhouse gas emissions with the aim of limiting global warming to below 2° C (preferably 1.5 º C).

penalty of making the environmental and social objectives unfeasible. Sustainability and long-term vision are inseparable, and it is vital to reduce unjustified pressure to obtain short-term returns and to provide transparent information about the environmental risks of activities.

To achieve the stated purposes, the Commission proposes a set of actions to be carried out in a phased and articulated way:

- Objective of *reorienting capital flows* towards a sustainable economy:
  - Action 1: Establish an EU classification system (taxonomy) for activities in the realm of sustainability;
  - Action 2: Create standards and labels for "green" financial products;
  - Action 3: Foster investment in sustainable projects;
  - Action 4: Incorporate sustainability when providing financial advice; and
  - Action 5: Develop sustainability benchmarks.
- Objective of *mainstreaming sustainability into risk management*:
  - Action 6: Integrate sustainability into credit ratings and market research;
  - Action 7: Clarify institutional investors' and asset managers' duties in terms of sustainability; and
  - Action 8: Integrate sustainability into prudential requirements.
- Objective of *fostering transparency and long-term vision*:
  - Action 9: Strengthen sustainability disclosure and accounting rule-making; and
  - Action 10: Promote sustainable corporate governance and mitigate the short-term vision in capital markets.

3. European Union sustainability taxonomy: the "kick-off"

3.1. *Required antecedence of Action 1*

Action 1 is, to a certain extent, the heart of the Action Plan. The transition to a sustainable economy depends primarily on a relative consensus on what is meant by "sustainable". The financial sector supports the economy by financing economic activities, and the aim of the European Union Action Plan is to direct this financing towards *sustainable* economic activities in order to restructure the system, making it more consistent with the environmental objectives. As is easily understood, clarity about what activities can be considered "sustainable" is a prerequisite for this strategy.

In these terms, Action 1, designed to establish a classification system of sustainable activities, is considered basilar and a condition, direct or indirect, of the implementation of the other actions. It is easy to conclude that the remaining nine actions all presuppose the precise definition of what economic activities, and, inherently, what investments, are considered sustainable.

In addition to this dependency, which runs through the various actions of the Plan, the relevance of creating a taxonomy for sustainable activities stems from various studies and reports on responsible investment, which have in common exactly the prioritisation of the development of a classification system. This taxonomy has, for experts in the field, a wide range of potential uses, such as identifying eligible assets for funding under "green" or "sustainable" Community funds; allowing investors to understand the degree of sustainability of their portfolios; providing economic agents and investors with decisive information so that they can design their investment decisions based on long-term sustainability;

combating "greenwashing"[11]; and enabling the consideration of sustainability for asset value setting.

Within the European single market, the relevance of the sustainability taxonomy is further strengthened. In fact, given the international commitments of the states, it would be expected that at the national level, authorities would begin to explore the creation of labels for sustainable financial products and eventually create taxonomies of their own. This scenario would generate unquestionable challenges. First, it would exacerbate national barriers to the functioning of the single market. Furthermore, it would mean the fragmentation of the market because various competition problems would arise, hampering investors and economic operators in particular. The barriers and fragmentation of the market would discourage cross-border investments, as they would entail increased information costs for investors who want to invest in foreign legal systems. Moreover, this scenario would be harmful for economic operators, as it would become more difficult to attract capital for sustainable activities, either because investors would be less receptive to investing due to the asymmetry of information or because the operators would incur increased costs to present the same activity as sustainable in various legal systems. Finally, the absence of a Community taxonomy would entail deeper regulatory divergences, which would discourage economic operators from expanding their businesses across borders. All these factors would result in the reduction of investor confidence and the obstruction of the functioning of the market, damaging the goal of the growth of sustainable finance.

[11] "Greenwashing" means the promotion or presentation of a product or activity as "green", "ecological", "sustainable" or "eco-friendly" when, however, such product or activity has negative environmental impacts. Paraphrasing the definition established on the Action Plan (page 7, footnote 26), it means "the use of marketing to portray an organisation's products, activities or policies as environmentally friendly when they are not".

3.2. *Chronology*

Recognizing the necessary precedence of the creation of a European taxonomy in relation to the implementation of the other actions, the Commission intends to execute the Action Plan exactly through the creation of this taxonomy. However, by stressing the complexity and the highly technical nature of the process, the EU 'executive arm' recognizes the necessity of an extended period of time to establish a solid system of classification, encompassing environmental and social factors. Therefore, the Commission proposes a staged approach. In the first phase, a taxonomy will be created on mitigation and adaptation to climate change activities, including some environmental activities. Subsequently, the taxonomy of the Union will cover other activities with positive environmental impact and social activities.

For the concrete implementation of Action 1, the following event chain is predicted:

1. Presentation of a *legislative proposal* aiming to establish the legal basis of the taxonomy, whereby tools to develop the classification system will be created;
2. Establishment of a *technical group of experts* in sustainable finance;
3. Publication of the *report of the expert group* with a first version of the taxonomy based on an enlarged consultation with stakeholders; and
4. Development and regular updating of the taxonomy through *delegated acts*.

To date, the outlined steps have been carefully followed: as of the second quarter of 2018, a proposal for a regulation on the matter had been submitted, and the expert group, whose report was to be made available by the end of June 2019, had been appointed.

3.3. *Proposal for a regulation*

The proposal for a regulation establishes uniform criteria for determining whether an economic activity is environmentally sustainable and defines the process of creating a multilateral platform to operationalize the classification system and to monitor its practical application.

Article 3 of the proposal is the nuclear precept in the identification of environmentally sustainable activities — it catalogues the four cumulative criteria that must be verified to classify a given economic activity as sustainable:

1. The economic activity contributes substantially to one or more of the environmental objectives;
2. The economic activity does not significantly harm any of the environmental objectives;
3. The economic activity is exercised in compliance with the minimum safeguards; and
4. The economic activity complies with the applicable technical screening criteria.

Each of the criteria presupposes the proper densification, which implies articulation between the various precepts of the proposal, which should operate on the following terms:

1. The economic activity *contributes substantially* to one or more of the *environmental objectives*:
   - *Environmental objectives* — listed in article 5
   - *Substantial contribution* — concept developed in articles 6 to 11
2. The economic activity *does not significantly harm* any of the *environmental objectives*:
   - *Environmental objectives* — listed in article 5
   - *Absence of significant harm* — concept developed in article 12
3. The economic activity is exercised in compliance with the *minimum safeguards*:
   - *Minimum safeguards* — expression defined in article 13

4. The economic activity complies with the applicable *technical screening criteria*:
   - *Technical screening criteria* — expression explained in articles 6(2), 7(2), 8(2), 9(2), 10(2) and 11(2) and in article 14.

As has been shown, article 5 of the proposal lists the six "environmental objectives" for the purposes of the community taxonomy. They 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 control; and 6) protection of healthy ecosystems. For a particular economic activity to qualify as "environmentally sustainable", it will have to contribute substantially to one of these objectives and not significantly harm any of them[12]. The proposal densifies the indeterminate concepts contained therein — "contributing substantially" and "not significantly harming" — in the subsequent provisions. Articles 6 to 11 contain illustrative catalogues of substantial contributions to each of the environmental objectives, treating them autonomously by disposition. Article 12 clarifies what is considered to be significant harm for each of the environmental objectives, which are also autonomously considered by paragraph. There is, therefore, an intersection between each of the environmental objectives and the requirements of "substantial contribution" and "absence of significant harm" that is absolutely fundamental in the structure of the proposal for a regulation. The autonomous treatment of each objective by reference to both requirements denotes the highly technical

[12] With the cumulative requirement of the two prerequisites, the proposal hinders the consideration of an activity as environmentally sustainable when, although contributing to an environmental objective, it produces other, negative environmental effects.

and complex nature of the matter, evidencing the impropriety of abstract and generic criteria.

The following precept — article 13 — clarifies the meaning of the term “minimum safeguards” by considering the scope of the third requirement mentioned above. The provision explains that what is concerned is the work procedures implemented by companies in compliance with the principles and rights deriving from the eight fundamental conventions identified in the declaration of the International Labour Organisation.

After considering the first two requirements in articles 5 to 12 and the third requirement in article 13, article 14 refers to the fourth and last requirement of classification of an activity as sustainable from the environmental point of view. This precept must be articulated with paragraphs 2 of articles 6 to 11, as there is (also here) a need to consider each of the environmental objectives individually. The “screening criteria” in question constitute parameters or measures of a quantitative or qualitative nature that will enable the concrete discernment of what *real* economic activities contribute substantially to or significantly harm each environmental objective. At its core, this fourth requirement implies the passage of an abstract perspective to a concrete one through the application of limits, quantities, values, etc. These criteria will be designed by the Commission through delegated acts to be adopted in a phased manner — the proposal stipulates a deadline for drafting each delegated act[13]. Regarding the volatility that characterizes this matter, constant monitoring of the application of the criteria and its periodic review are foreseen.

Regarding the classification criteria, it is important to question whether the formulations presented in articles 6 to 12 on what are considered “substantial contributions” and

[13] *Vide* articles 6(4), 7(4), 8(4), 9(4), 10(4) and 11(4). The process will be closed at the end of 2022.

"significant harm" are sufficiently clear and accurate to ensure the necessary legal certainty in the matter. The Regulatory Scrutiny Board commented on the topic and required the improvement of the precepts. In fact, the innocuousness and repeatability of the definitions presented are notorious, indicating that additional work is still necessary for the proposal to become legislation with the adoption of the definitive Regulation.

The proposal also regulates the creation and functioning of a "Platform on Sustainable Finance" (article 15). This platform will accompany the entire process of elaboration and implementation of the taxonomy and its subsequent application, assuming the role of a meeting centre for the actors interested and directly involved.

4. **Conclusion**

The development of the European Union taxonomy for classifying sustainable activities is, as mentioned, the "kick-off" of the implementation of the Action Plan on Sustainable Finance. From this categorization, we will be able to identify sustainable investments — investments that finance one or more economic activities considered sustainable (article 2(1), paragraph (a) of the Proposal for a Regulation) — and their degree of sustainability. In this way, the taxonomy, when operational, will provide clarity and safety on what is "green", thereby increasing confidence in the market and levelling the competition, which will promote investment in sustainable projects and assets. This factor, when allied to others, most importantly the implementation of the other actions foreseen in the Commission's Plan, will contribute to (re)directing important capital flows to sustainable sectors, thus assisting the transition to a circular, low-carbon and efficient economy that is more stable and compatible with international environmental protection targets.

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