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The European taxonomy: a stepping stone towards sustainable economy?

Ludivine de Quincerot
Head of Financial
Analysis & ESG team

Andrea Sekularac
Project Manager
Sustainable Investment

In 2018, in the wake of COP21, the European Commission adopted an action plan to efficiently integrate the sustainable transition into the economy. This plan included a new standard – called "taxonomy" – for determining the "sustainable" character of an economic activity.

A rigorous framework and quantifiable objectives

The taxonomy could be compared to a two-volume encyclopaedia of the sustainable economy with environmental (green) and social (pink) components. It is not just any other layer of post-COP21 European regulations, but rather the crowning touch of other layers, such as SFDR[1], MiFID[2], Ecolabel[3], CSRD[4] and EU GBS[5]. It aims to create a rigorous and harmonised framework based on standardised data. In short, this is a non-exhaustive and constantly evolving list of criterias for determining an economic activity's contribution to defined sustainability objectives, which prevents evaluation discrepancies. This new regulatory environment applies to investors as much as companies and governments. Through its materiality-based approach, it aims to identify the key challenges, and those sectors most likely to address them. However, not all economic sectors are expected to pursue all objectives and, within one sector, not all activities are necessarily eligible. For this reasons a list of essential sectors has been drawn up for each objective. For companies in those sectors, the first step is to determine the potential eligibility of their activities based on the listed criteria and, then, how well these activities are aligned with said criteria. This means that one objective shouldn't be achieved at the expense of another and that companies must, at the very least, comply with international standards, such as those of the OECD[6], the ILO[7], and other organisations in the areas of human rights and the environment.

A gradual implementation

As of 1 January 2022, only the environmental taxonomy had come into force, and even that one is unfinished, with just two of the six listed objectives being applied – climate change mitigation and climate change adaptation. Three types of activity are involved – "low-carbon" ones, which act directly in favour of the objective (wind, solar, etc.); "enabling" ones, which allow other actors to comply with the taxonomy's quantitative thresholds (insulation, charging stations, etc.); and "transitional" ones, meaning solutions meant to be the least-CO_2 short-term alternatives (natural gas vs. coal, etc.). After ensuring that the activity is eligible, its sustainable character must be ascertained. To do so, thresholds of each activity have been defined (e.g., CO_2eq emissions per km[8] of a vehicle in the case of the auto sector). Whether the activity meets or exceeds this threshold determines whether it can be considered sustainable.

(1) The Sustainable Finance Disclosures Regulation aims to provide a framework for integrating Environmental, Social and Governance (ESG) challenges by financial market participants.
(2) The Markets in Financial Instruments Directive is a European directive that sets rules for financial institutions.
(3) The European Écolabel is a reliable and official label created in 1992 by the European Commission to encourage the development and use of goods and services that are safer and more environmentally friendly.
(4) The Corporate Sustainability Reporting Directive (CSRD) is a European directive that sets new extra-financial reporting standards and obligations for large companies in Europe.
(5) European "green bond" standards that aim to encourage financing of sustainable investments by stating clearly the assets and projects that funds may be invested in.
(6) Organisation of Economic Cooperation and Development.
(7) International Labor Organization.
(8) CO_2 equivalent compares the emissions of various greenhouse gases based on their global warming potential by converting the quantities of these gases into an equivalent of carbon dioxide having the same global warming potential.

Once it has been phased in, and while its objectives are meant to be unchanged, the taxonomy is designed as an evolutionary process that adjusts to new environmental and social issues and to policy changes. In that regard, the debate surrounding the classification of natural gas and nuclear power, as well as the issue of financing the weapons sector have become particularly salient since the start of the Russian-Ukrainian war. Ultimately, this standard is meant to cover all economic activities based on their contribution to an environmental or social goal.

The green taxonomy lists economic activities that are compatible with the achievement of 6 environmental objectives:

- Climate change mitigation *(effective from 1 January 2022)*
- Adaptation to climate change *(effective from 1 January 2022)*
- Sustainable use and protection of water and marine resources
- Pollution prevention and control
- Transition to a circular economy, prevention and recycling of waste
- Protection of ecosystems

A praiseworthy intention faced with a lack of data

The companies themselves are meant to determine eligibility and alignment by dissecting their activities and value chains based on three criteria: revenues, capex[9] and opex[10]. This has proven to be challenging, and, ultimately, they won't have to disclose this information until 2024, for their 2023 financial years, even though the taxonomy became effective for financial actors in January 2022. This lag is forcing investors to gauge the "taxonomic profile" of their investments based on incomplete data. This could lead short-term dependence on external service providers, as many companies lack the in-house resources necessary, and it may also hinder comparability.

Moreover, the initial available data will be calculated on the basis of revenues and will therefore provide a mere snapshot that is not representative of companies' dynamics. However, once companies are able to provide capex-based data, we will have a more accurate vision of their orientation and trajectory. The taxonomy will then help provide a convergence and a homogeneity for objectively grasping an activity's contribution to the transition.

Regulatory authorities are perfectly aware of the limits of implementing the taxonomy but have chosen to initiate the movement to encourage investors and companies to understand these concepts and take them on board at an earlier stage. In light of the aforementioned obstacles, the figures should be approached cautiously, but we are confident that, as all actors come to understand this new situation better, data will trend towards greater convergence and become a more easily exploitable standard. European institutions therefore want to incentivise financial players to make a long-term commitment to the transition, while providing visibility in activities likely to benefit from political leverage (Green Deal, ECB, etc.). However, this process must unfold in an orderly way in order to prevent any negative impact on price variations and economic growth.

So how will the taxonomy apply to the real world?

The taxonomy is just getting started, but its goal is to facilitate the steering of financial flows into activities contributing to a real transition, in line with the Paris Agreement and the United Nations' Sustainable Development Objectives. For companies, it is an opportunity to squeeze more value from a part of their business model that may have been overlooked by investors, and to provide greater transparency throughout their value chains. Investment managers, meanwhile, will have a role in accelerating the process by providing backing and by making companies aware of the need to disclose data on their business activities, while promoting a strategic shift towards the transition. For end-investors, this standard should provide greater clarify in the offering of sustainable investment strategies and facilitate comparisons so they can better choose those that coincide with their convictions and thus give their investments greater meaning. The taxonomy is meant to be a common yardstick rather than choosing the alpha and omega of sustainable funds. It should therefore avoid assessing management strategies based on their intrinsic features. Hence, a fund mostly invested in the renewable energy sector will necessarily have a greater taxonomic alignment than a fund invested in a diversity of transforming sectors. Even so, their approaches will still be complementary and will contribute to developing a sustainable economy.

(9) Capital expenditure.
(10) Operating expenditure.

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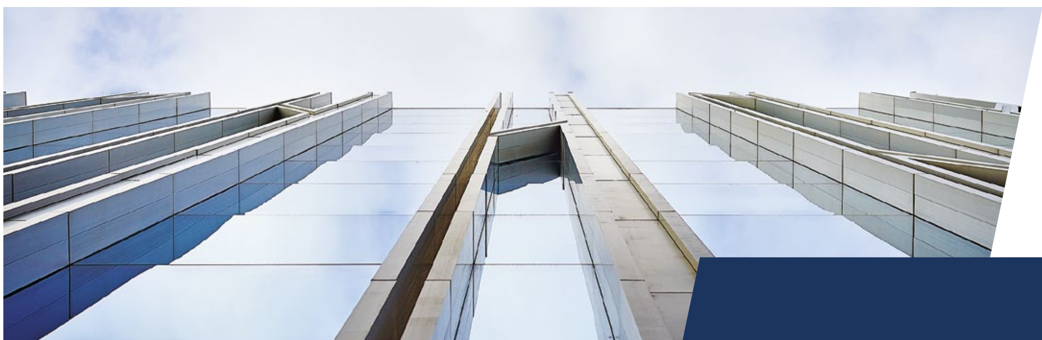

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