09 | December 2019

Brief

The Legislative Proposals to Support the Action Plan on Financing Sustainable Growth in Europe

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Abstract

FEEM Policy Brief

The goal of the Action Plan on Financing Sustainable Growth approved by the European Union in March 2018 is to integrate sustainability considerations into European financial policy framework. To support this, several legislative proposals have been issued which have been further specified in Technical Expert Group on Sustainable Finance (TEG) Reports published from January to September 2019. These reports provide recommendations and develop minimum requirements on specific issues referring to: Taxonomy, creating a unified classification system on what can be considered an environmentally sustainable economic activity; the introduction of a European Green Bond Standard to create a voluntary standard to enhance the effectiveness and comparability of the green bond market; common criteria to create European Climate Benchmarks to avoid misleading users of financial products. This document gives an overview of all these measures, highlighting moreover, their impact and benefits for the different players in the market.

01 Policy Context

In committing to the SDGs and climate-related goals through the Paris Agreement, the EU and its Member States, in March 2018, approved a plan called Action Plan on Financing Sustainable Growth to pave the path of sustainable investments. These measures provide signals to corporations and investors about future economic trends in terms of investment opportunities and risks, but also on the duty of capital markets to re-orient capital flows especially to meet the goal of a 40% reduction in GHG emissions. Practically, Europe needs an additional €175 to 290 billion a year of private investment to meet climate goals.

02 Actions on Sustainable Finance on EU-level

The Action Plan on Financing Sustainable Growth promotes 3 main objectives:

1. reorient capital flows towards sustainable investment, in order to achieve sustainable and inclusive growth
2. manage financial risks stemming from climate change, environmental degradation and social issues
3. foster transparency and long-termism in financial and economic activity

On 24 May 2018, the European Commission (EC) Technical Expert Group (TEG) published a package of measures which consist of the legislative proposals to support the Action Plan:

1. A unified EU classification system – called Taxonomy – to establish whether an economic activity is environmentally sustainable;
2. An EU Green Bond Standard Improving disclosure requirements on how institutional investors integrate environmental, social and governance (ESG) factors in their risk processes;
3. A new category of benchmarks which will help investors compare the carbon footprint of their investment;
4. Guidelines to improve corporate disclosure of climate-related information (SPANI).

The Taxonomy procedure 2018/0178/COD

This regulation establishes the framework to create a unified classification system – called Taxonomy – on what can be considered an environmentally sustainable economic activity to be financed through a sustainable investment. Since now, a unique definition of sustainable investment was not present. Thus, the Taxonomy provides clarity and transparency on economic activities that can be labelled as environmentally sustainable to all participants in the financial and economic market, hence enabling informed decision-making, and attract environmentally conscious financial funds.

The Taxonomy provides six environmental objectives to which economic activities must contribute (Article 5):
1) climate change mitigation
2) climate change adaptation
3) sustainability use and protection of water and marine resources
4) transition to a circular economy, waste prevention and recycling
5) pollution prevention and control
6) protection of healthy ecosystems

According to the Article 3, an economic activity shall be environmentally sustainable where that activity complies with all these criteria:
- Contribute substantially to one or more of the environmental objectives
- Do no significant harm to any other environmental objective
- Comply with minimum social safeguards
- Comply with the technical screening criteria

The Taxonomy Technical Report

In this regulatory environment, on June 2019, the TEG published a Taxonomy Report which provides an overview of what the taxonomy is, what it is not, and how to use it in practice. The TEG has been asked to develop recommendations for technical screening criteria for economic activities that can make a substantial contribution to climate change mitigation or adaptation, while avoiding significant harm to the other environmental objectives (3-6).

To define which economic activities can be considered environmentally sustainable the TEG has adopted the NACE industrial classification system which is largely compatible with international and Member State frameworks.

The TEG's Technical Report provides several recommendations, including:
- A technical screening criterion for 67 activities that can make a substantial contribution to climate change mitigation across the sectors agriculture, forestry, manufacturing, energy, transportation, water and waste, ICT and buildings; moreover, the activities have also been assessed for significant harm to other environmental objectives.
- A methodology and examples for evaluating substantial contribution to climate change adaptation.
- Useful case studies for investors preparing to use the Taxonomy.

Three concepts ground the Taxonomy of business activities to be reached through process or product innovation: climate change mitigation, climate change adaptation and Do no significant harm (DNSH). For climate change mitigation are considered those activities that to the stabilization of greenhouse gas concentrations in the atmosphere at a level which prevents dangerous anthropogenic interference with the climate system (by avoiding or reducing greenhouse gas emissions or enhancing greenhouse gas removals). Among this set of activities, the TEG distinguishes between the one greening of and the ones greening by. The TEG identifies three kinds of activity can make a substantial contribution: 1) Activities that are already low carbon: these are already compatible with a 2050 net zero carbon economy; 2) Activities that contribute to a transition to a zero net emissions economy in 2050 but are not currently operating at that level; and, 3) Activities that enable those above. Climate change adaptation is indeed context- and location-specific and requires the use of a process-based approach to determine if an activity contributes to adaptation and broader system's climate resilience reducing the negative effects of the current and expected future climate or preventing an increase or shifting of negative effects of climate change. For DNSH, indeed, it is intended an activity contributing to climate change mitigation must avoid significant harm to climate change adaptation and the other four environmental objectives (3-4-5-6).

The investor disclosure procedure 2018/0179/COD and amending Directive (EU) 2016/2341

In the absence of harmonised Union rules on sustainability-related disclosures to end-investors, it is difficult for end-investors to effectively compare different financial products and services in different Member States as to their environmental, social and governance (ESG) risks and sustainable investment targets. With the proposal 2018/0179/COD and amending Directive (EU) 2016/2341 the European Commission commits to create standards and labels for green financial products. This proposal aims to improve disclosure requirements on how financial intermediaries should integrate ESG factors in their investment decision making, portfolio management and advisory process. The standard would solve several barriers in the current market, including reducing uncertainty on what is green by linking it with taxonomy, standardising verification and reporting processes.

Proposal for an EU Green Bond Standard (GBS)

The TEG has been asked to prepare a report on an EU Green Bond Standard, building on current best practices. The aim is to create a voluntary, non-legislative standard to enhance the effectiveness, transparency, comparability and credibility of the green bond market and to encourage the market participants to issue and invest in EU green bonds. The TEG recommends that an EU Green Bond could be any type of listed or unlisted bond or capital market debt instrument issued by a European or international issuer that is aligned with the EU GBS. The TEG suggests that the EU should comprise four critical elements:

- Alignment with EU-taxonomy: earnings from EU Green Bonds should go to finance projects that contribute to at least one of the six taxonomy Environmental Objectives and do not significantly harm any of the other objectives and comply with the minimum social safeguards.
- Publication of a Green Bond Framework, which confirms the voluntary alignment

of green bonds issued with the EU GBS, explains how the issuer's strategy aligns with the environmental objectives, and provides details on all key aspects of the proposed use-of-proceeds, processes and reporting of the green bonds.

- Mandatory reporting on use of proceeds and on environmental impact.
- Mandatory verification of the Green Bond Framework and final allocation report by an external reviewer: the European Securities and Markets Authority (ESMA).

Climate Benchmarks procedure 2018/0180/COD and amending Regulation (EU) 2016/1011

These two regulations stress the importance of determining a climate benchmark to avoid misleading users of financial products. In its interim report, the TEG published: "a climate benchmark is an investment benchmark that incorporates – next to financial investment objectives - specific objectives related to greenhouse gas (GHG) emission reductions and the transition to a low-carbon economy - based on the scientific evidence of the IPCC - through the selection and weighting of underlying constituents".

During these years, different categories of low carbon indices with various degrees of ambition have emerged in the marketplace, such as: low-carbon benchmarks and positive carbon impact benchmarks. While low-carbon benchmark is based on decarbonising a standard benchmark, the second one is more ambitious in selecting companies on account of their carbon emission savings exceeding the stocks' residual carbon footprint. Despite differences in objectives and strategies, all of these benchmarks were considered as "low-carbon benchmarks"; this led to the fragmentation of the internal market and a confusion on the investor side. Therefore, on 25 February 2019, the EC amended the Regulation 2016/1011 introducing two types of benchmark:

- EU Climate Transition Benchmark (EU CTB): it brings the resulting benchmark portfolio on a decarbonisation trajectory, meaning a measurable, science-based and time-bound trajectory to reduce carbon emissions.
- EU Paris-aligned Benchmark (EU PAB): it brings the resulting benchmark portfolio's carbon emissions in line with the Paris Climate Agreement goal to limit the global temperature to 1.5°compared to pre-industrial levels.

In addition, the amendment requires the ESG disclosure for all benchmarks. The TEG proposes to set out disclosure requirements based on the market's current understanding of how ESG and climate-related considerations can be integrated into the valuation of assets across various asset classes. The recommendations on minimum disclosures for the methodology document and specifications for the benchmark statements therefore vary based on the maturity of ESG data and considerations in each asset class.

These climate benchmarks have several different purposes: (i) allow a significant level of comparability of climate benchmarks methodologies; (ii) provide investors with an appropriate tool that is aligned with their investment strategy; (iii) increase transparency on investors' impact, specifically regarding climate change and the energy transition.

In its report, the TEG identifies several criteria for qualification as an EU CTB or an EU PAB:

- Climate benchmarks must demonstrate a significant decrease in overall GHG emissions intensity compared to their underlying investment indices: the minimum relative decarbonization is set at 30% for EU CTBs and 50% for EU PABs.
- Climate benchmarks must be sufficiently exposed to sectors relevant to the fight against climate change: decarbonization cannot happen through a shift in the allocation from sectors with high potential impact on climate change and its mitigation (e.g. energy, transport, manufacturing) to sectors with inherently limited impact (e.g. health care, media).)
- Climate benchmarks must demonstrate their ability to reduce their own GHG emissions intensity on a year on-year basis. This minimum 'self-decarbonization' rate has been set in accordance with the global decarbonization trajectory implied by IPCC's most ambitious scenario: 1.5°C with no or limited overshoot
- When a "green to brown share ratio" is calculated by benchmark administrators based on an estimation of the green and brown shares of revenues from underlying issuers, relatively to the underlying investment universe or parent index, this ratio must be at least equal for EU CTBs and multiplied by at least 4 for EU PABs.

TEG final report on Climate benchmarks and benchmarks' ESG disclosures

On 30 September 2019, the TEG published the final version of the report in which have been added further key features of climate benchmarks that should exclude companies involved in controversial weapons, companies having been found in violations of global norms or in controversies arising from significant harm of at least one of the 6 environmental objectives.

Moreover, EU PABs shall further exclude companies that:

- derive 1% or more of their revenues from coal exploration or processing activities,
- derive 10% or more of their revenues from oil exploration or processing activities,
- derive 50% or more of their revenues from natural gas exploration or processing activities or
- derive 50% or more of their revenues come from electricity generation with a lifecycle GHG intensity higher than 100 gCO2e/kWh

This report it will be use as a basis to the drafting of delegated acts by the Commission, which will be subject to a formal public consultation and are expected to be adopted in early 2020.

03 What are the impacts and the benefits of these measures?

The taxonomy aims to establish a common language in order to define concepts like 'green', 'responsible', and 'sustainable' applied to investments, and it brings sustainable finance in practice, answering at the SDGs call. With these measure investors can be helped in drawing a cause-effect analysis of their investments, in better monitoring the ESG impacts of their investments, but also they can avoid any harm coming from a reputational risk, ensuring a resilient business strategy. In October 2019, the International Platform on Sustainable Finance (IPSF) has been launched with the aim of boosting the mobilisation of private capital towards environmentally sustainable investments and providing to all the stakeholders the information needed.

The GBS will led to several positive impacts, among which there are the conversion of bond markets to green, increasing the capital flows into green projects, and fostering the transparency and reporting avoiding greenwashing. Establishing a set of regulatory definitions for the green finance, these measures will have an indirect impact in incentivising businesses in improving the track records of ESG performance with a capillary analysis, for instance adopting input data coming from the Product and Organisation Environmental Footprint methods.

Several stakeholders will take benefit from these measures, such as:

- Financial markets participants (banks and insurers), through the integration of sustainability factors in their investment decisions
- Companies, by promoting the incorporation of sustainability into their strategy, although they have costs derived to the collection and management of data needed to assess the compliance with the defined screening criteria.
- Retail consumers, they will benefit from the increased transparency, easier access to green products (with reduced risk of greenwashing), and better comparability
- Institutional investors (pension funds and insurance companies) who protect a significant share of their assets against various investment risks related to climate change and the transition to a low-carbon economy.

Policy Conclusions

The institutional recognition of the role that sustainability plays in the financial market to face climate change and sustainable development, are beginning to radically modify the financial institutions' attitude towards ESG-risk and related opportunities. As we have seen in this brief, a greater and stricter regulatory framework is on the horizon: the recent legislative reforms at EU level on sustainable finance and the adoption of such a new regulatory framework are almost completed. Nevertheless, being the EU and its Member States the largest provider of public climate finance, is also needed that they reach the objective to increase their international climate finance contribution towards the $100 billion per year goal set for industrialised countries by 2020 and through until 2025.

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