THE EU TAXONOMY

Seeking to implement the European Green Deal and the Paris Agreement, the EU has developed a classification system (a "Taxonomy") that is supposed to help investors and companies to better understand which economic activities are environmentally sustainable.

WHAT IS THE TAXONOMY?

Launched in 2020, the EU Taxonomy (hereafter: the Taxonomy) is a classification system to determine whether a specific economic activity is environmentally sustainable. It was designed to translate the EU's environmental objectives into criteria with which the environmental sustainability of specific economic activities can be assessed. Consider this example: If you operate in the transport sector and you want to find out in how far freight transport services by road (e.g., through trucks) would meet EU environmental objectives, the Taxonomy will help with the assessment. Hence, the Taxonomy is primarily a transparency tool with clear criteria. Together with sustainability disclosure regulations, the Taxonomy will require companies and investors to disclose in how far their economic activities are Taxonomy-aligned. As of March 2022, the EU Taxonomy allows for the classification of environmentally sustainable activities. However, the EU has already proposed the basic structure of a Taxonomy system that allows to judge social sustainability as well. It can be expected that the social Taxonomy will soon be turned into EU regulation.

WHAT IS THE TAXONOMY NOT?

The Taxonomy itself is not a rating system that would allow an investor to determine "good" or "bad" companies. It does not set binding requirements on companies' environmental performance. Rather, it allows investors to see the environmental performance of companies insofar as companies' economic activities are (not) Taxonomy-aligned. Further, the Taxonomy is also not a list of mandatory economic activities that investors should focus on. However, it helps investors to assess the environmental performance of investee companies.

HOW DOES THE TAXONOMY DEFINE WHAT COUNTS AS ENVIRONMENTALLY SUSTAINABLE?

The Taxonomy works with *economic activities* (e.g., freight transport services by road) as its unit of analysis. Economic activities are assessed through performance criteria (so-called "technical screening criteria") in terms of whether they make a substantial contribution to six environmental objectives.

1. Climate change mitigation (i.e., reducing the impacts of climate change),
2. Climate change adaptation (i.e., adjusting to current and future effects of climate change),
3. Use and protection of water and marine resources,
4. Transition to a circular economy,
5. Pollution prevention and control, and
6. Protection and restoration of biodiversity and ecosystems

An economic activity will count as Taxonomy-aligned if three conditions are met:

- The economic activity makes a substantial contribution to at least one of the six environmental objectives (for each economic activity there are predefined performance criteria to judge whether such a contribution exists),
- The economic activity does not cause any significant harm to any of the other environmental objectives (for each economic activity there are predefined performance criteria when such significant harm would exist),
- The economic activity must comply with minimum social safeguards (i.e., alignment with ILO's core labour conventions, the OECD Guidelines for Multinational Enterprises, and the United Nations Guiding Principles on Business and Human Rights).

The EU designed the Taxonomy in a way that trade-offs between environmental objectives are reduced. In other words, if an economic activity would contribute to one objective but at the same time harm one or more of the other objectives, it would not count as Taxonomy-aligned.

This technical note was prepared by:
Andreas Rasche, Professor, Associate Dean, Department of Management, Society and Communication

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Consider the following brief example (see also EU Technical Expert Group on Sustainable Finance, 2019b: 12). A cement manufacturer aims at transitioning towards fewer greenhouse gas emissions. Right now, the company emits 0.6 tCO2 e per tonne of cement. The Taxonomy criteria state that cement manufacturing only makes a substantial contribution to climate mitigation if 0.498 tCO2 e per tonne of cement are reached. If the manufacturer changes its operations and meets the defined threshold and if cement production is set up in a way that the do-no-significant-harm criteria for the five other objectives are met, an investor could consider the company revenues associated with this activity to be taxonomy-aligned.

As of October 2021, the Technical Expert Group (TEG), which specifies the performance criteria, has defined criteria for the assessment of economic activities in several sectors, such as agriculture, forestry, and fishery; manufacturing; energy; water (incl. sewage, waste); transport; information and communication technology; and construction. The current performance criteria allow assessing of economic activities in these sectors only against two out of the six environmental objectives (i.e., climate mitigation and climate adaptation). The performance criteria for the remaining four objectives are expected to be published throughout 2022. The easiest way to access all performance criteria is through the EU Taxonomy Compass (https://ec.europa.eu/sustainable-finance-taxonomy/tool/index_en.htm).[1]

The Taxonomy is fixed through European regulation (European Parliament and Council of the European Union, 2020), while the performance criteria for each environmental objective are fixed through delegated acts (European Commission, 2021).

WHAT ARE THE CONSEQUENCES FOR INVESTORS?

As companies often have more than one economic activity, the Taxonomy regulation requires that companies disclose the percentage of revenue that is associated with the taxonomy-aligned activity. Also, if investors aim at disclosing what percentage of a fund contains taxonomy-aligned activities, they need to calculate the revenues of investee companies that are associated with these taxonomy-aligned activities. Figure 1 shows how investors could apply the Taxonomy to calculate what percentage of a green equity fund would be aligned with the Taxonomy.

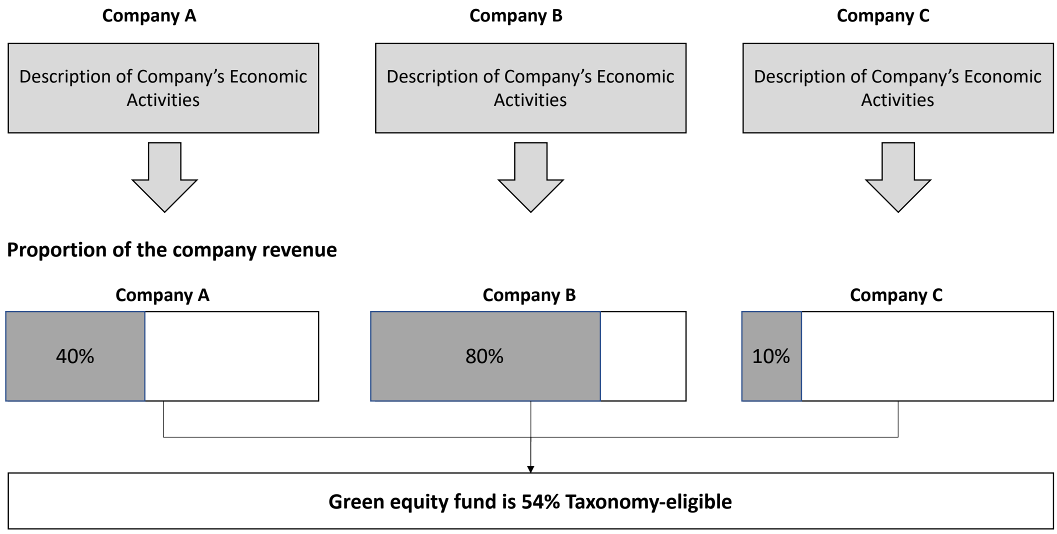

Figure 1: Applying the Taxonomy to an Equity Portfolio.
Adapted and modified from: EU Technical Expert Group on Sustainable Finance (2019a: 10)

The EU recommends a five-step approach that investors should follow to implement the Taxonomy (EU Technical Expert Group on Sustainable Finance, 2019b: 62).

1. Identify the relevant economic activities conducted by the investee company or those covered by the financial product (e.g., use of proceeds in the case of a bond).
2. For each potentially eligible economic activity, verify whether the company meets the performance criteria that determine whether this economic activity contributes to at least one of the six predefined environmental objectives.
3. Verify that the company meets the do-no-significant-harm performance criteria for those environmental objectives to which the

1 A number of economic activities in different sectors still have to be assessed by the TEG at this stage. Some activities were also not included while developing performance criteria; mostly in those cases where it was clear that they could not make a substantial contribution to any of the objectives or where they clearly violated the do-no-significant-harm condition.

activity does not make a substantial contribution. Most likely, this will be done through due diligence assessments.
4. Verify that the company meets the minimum social safeguard criteria.
5. Calculate the percentage of revenue derived from Taxonomy-aligned activities for investee companies.

WHO WILL NEED TO USE THE TAXONOMY?

The Taxonomy should be used by financial market participants (incl. asset owners, asset managers, financial advisors). The new Sustainable Finance Disclosure Regulation (SFDR), which came into effect in 2021, requires investors to consider the Taxonomy when disclosing sustainability information. The European Commission (2021a: 3) states: "The SFDR requirements are linked with those under the EU Taxonomy by including 'environmentally sustainable economic activities' as defined by the Taxonomy Regulation in the definition of 'sustainable investments' in the SFDR." Practically speaking, Taxonomy-alignment matters most for those financial products that have sustainable investment directly as their objective (so-called "dark green" products under Article 9 under Regulation 2019/2088 of the European Commission).

The Taxonomy will also apply to those non-financial companies that are in scope for the new Corporate Sustainability Reporting Directive (CSRD), which will apply for the fiscal year beginning on 1 January 2023 at the latest. CSRD will require companies to report the percentage of their activities that are aligned with the Taxonomy (European Commission, 2021b). In practice, this means that companies will need to report the percentage of their revenues coming from Taxonomy-aligned activities as well as the percentage of future revenues associated with activities that are Taxonomy-aligned.

WHY IS A TAXONOMY NEEDED?

There are many reasons why such a Taxonomy makes sense. Most of all, it provides much-needed transparency in the context of financial products associated with sustainability. As sustainable investing is turning into a mainstream activity, it is important that investors can signal in credible ways what percentage of their investments really are environmentally sustainable. If properly implemented, the Taxonomy will save time and money for investors, and it will prevent greenwashing and therefore allow investors to manage their reputational risks. It will reward truly "green" companies, and it will make it easier for investors to select holdings and express investment preferences.

References

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