Webinar note on international taxonomies

1) The EU global ambition on sustainable finance

The EU Commission expressed, in its renewed sustainable finance (SF) strategy published in July 2021, the aim to foster global ambition on this topic. Notably, the general objective is to focus the strengthened ambition in developing international SF initiatives and standards, embracing the double materiality principle[1] as well as beefing up the role of the EU taxonomy internationally.

-The first specific objective of the global ambition chapter of the renewed strategy is to promote a strong consensus in international forums, notably by:

- "Exporting" the double materiality principle and common objectives and principles for sustainable taxonomies.
- Strengthening international governance on SF and advocating to expand the Financial Stability Board mandate to integrate the double materiality perspective
- Provide the private sector with usable tools and metrics (such as taxonomies).

-The second specific objective aims at advancing and deepening the work of the International Platform on SF (IPSF), proposing a stronger governance structure. During COP26 the IPSF published:

- A statement reaffirming its commitment on working towards "comparable and interoperable sustainability alignment tools".
- An annual report, a report on disclosure policy measures across IPSF jurisdictions[2], and a report on common ground taxonomy and on sustainability disclosures

We should also expect the IPSF to:

- Strengthen its governance and expanding its work on new topics such as biodiversity and transition finance
- Strengthen its cooperation and interaction with the private sector

-The third specific objective focuses on enhanced support to low- and middle-income countries in scaling up access to sustainable finance, notably by creating a HLEG tasked to identify challenges and opportunities that SF presents in EU partner countries, whilst supporting the implementation of the external dimension of the EGD.

2) Strengths and weaknesses of the EU approach

As seen, together with the double materiality principle, the role of the EU taxonomy will be crucial in mainstreaming the EU sustainable finance framework across the globe. The double materiality principle will represent a new obligation for companies to report how their activities impact the climate. However, a company should not only follow laws and regulations but should be in a context where self-assessment, based on general principles, make sense for improving its competitive conditions. Overall, ignoring market forces - as well as the need to incentivize and mainstream sustainability in the core decision making processes (i.e., not only in the reporting rules) of companies, shareholders, and investors - would represent a missed opportunity for legislators when setting the right impetus toward a decarbonized society.

On top of this general consideration regarding sustainability disclosure, ERCST identified several strengths of the EU taxonomy policy process, notably:

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[1] Double materiality is an extension of the key accounting concept of materiality of financial information. Information on a company is material and should therefore be disclosed if "a reasonable person would consider it [the information] important", according to the US Securities and Exchange Commission. Thanks to the work by the TCFD, it is now widely accepted within financial markets that climate-related impacts on a company can be material and therefore require disclosure. The concept of double materiality takes this notion one step further: it is not just climate-related impacts on the company that can be material but also impacts of a company on the climate – or any other dimension of sustainability, for that matter (often subsumed under the environmental, social and governance, or ESG, label). (Source: LSE)

[2] And on Brazil and the US

- clear principles set in the EU regulation (definition of 6 environmental objectives, substantial contribution to at least one of them, do no significant harm)
- at an advanced stage compared to other jurisdictions internationally
- it will surely help in shifting investments towards sustainable activities relevant for a carbon neutral society
- for certain activities, it sets the end point and give the overall steer

However, in view of ERCST, there are some areas that merit further discussion. We decided to structure them in 3 sections (which are based on issues identified by stakeholders during the public consultation):

1) Integrity:
    - Risk of becoming a political exercise (current nuclear and gas debate at EU level) influencing the determination of energy mixes of member states
2) Practicality:
    - Taxonomy is not at entity level and it's difficult to decline it to accommodate transition nuances at entity level. The taxonomy was indeed designed for the financial corporates rather than non-financial corporates.
3) Market interactions:
    - inconsistencies between the EU taxonomy design and the core objectives of financial regulation (stabilizing financial system, limiting risk taking, efficient allocation of capital). Thus, by exporting the EU taxonomy, the EU may steer the international agenda away from a free market-based economy (i.e. less based on systemic market incentives, where the risk is transferred from the market to the regulators
    - Risk of losing the focus on beefing up carbon markets internationally, designing the right market incentives at global level (also considering the Article 6 approval at COP26). Banks want indeed to go green, but with profitable projects. The important question, on top of what is green, is therefore how to get green and how to establish markets where the green risk return ratio makes economic sense

3) The EU adaptation to an international context

According to ERCST, the EU international attractiveness stands in the main principles set in the Regulation, which are already inspiring other jurisdictions' policy processes. Notably, the UK taxonomy, Malaysian taxonomy, Russian taxonomies, the taxonomy proposal in Singapore and the guidelines by AXA IM contain provisions similar to the DNSH criteria of the EU (OECD, 2021).

However, the EU technical screening criteria (TSC) are very prescriptive and it's implausible that the level of effort will be the same in other jurisdictions. The crucial thing in this context is therefore make sure that Taxonomies (and TSC) will be interoperable, even with different level of efforts across jurisdictions[3]. Indeed, proliferation of approaches should not result in lack of transparency and comparability.

To conclude, ERCST is very much interested in further understanding where the US stands in this debate and the approach we should expect from them. As a matter of fact, the long-term implications regarding the overall EU approach should be considered by EU policy makers when deciding for going towards a principle based or a prescriptive approach.

[3] IPSF and UN-DESA put forward in September 2021 a set of high-level principles for developing coherent approaches in the establishment of a taxonomy. The paper was conceived as an input to the G20 SFWG. The 7 principles are: positive contribution to SDGs; DNSH the SDGs; science-based; dynamicity; transparency and verification; contain all SDGs beyond climate; comprehensive assessment and value chain consistency. According to the report, by adhering to these principles, comparability and interoperability would be ensured.