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The EU Taxonomy: what next?

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1. Introduction

The EU Taxonomy was introduced in 2020 by the EU institutions as a classification system ('dictionary') which gives guidance to investors with respect to economic activities that contribute significantly to a sustainable economy and society. The declared goal is to direct the flow of private capital to finance transition towards a sustainable economy and to avoid the misuse of green labelling.

For more than 20 years, the market has developed multiple reporting tools based on the ESG[1] standards in response to the demand from investors for identifying which investments and economic activities can be seen as "sustainable". Over the years, the market demand and the public scrutiny gradually have been leading to the convergence of those tools reducing the risk of "green-washing", stemming from their abundance and the "catch-them-all" approach. However, the differences in methodologies still exist, sometimes producing divergent results[2].

Clarity and predictability are very important elements that investors seek in considering new activities. However, in the ambitious task of reaching a decarbonized but sustainable and industrial economy, market solutions should be given priority to ensure the highest possible effectiveness of decarbonisation efforts. Carbon pricing, through the EU Emission Trading System (ETS) is the flagship in that direction and should continue to be reference. Regulation should be imposed only when the market clearly fails to achieve the designated objectives. Governmental involvement in labelling activities as "sustainable" is a significant intervention in the economy and represents a shift in balance between market and regulation, towards the latter. Such an intervention interferes with the typical dynamics of markets, generating several challenges.

The Taxonomy being a product of institutions - not of market participants - became a label provoking political tension. Using this etiquette to one or another economic activity became a matter of principle, rather than a market instrument. The good illustration of this phenomenon are the political emotions around qualifying gas and nuclear energy as green activities under the Taxonomy. This tension spills over to other pieces of legislation impacted by the Taxonomy, for example the EU Green Bond Standard relying on the Taxonomy criteria, which became another battlefield in this debate.

This note explores the impact of the Taxonomy so far, whether it will achieve its objectives, and the way forward. It focuses on the consequences of the political nature of Taxonomy, its spill over to other EU policies, the challenges related to reporting, the concept of extension of the Taxonomy beyond the green category and draws the conclusions for future.

2. The (intended and unintended) impact of the Taxonomy

The Taxonomy regulation is only at an early stage of implementation. The first batch of screening criteria entered into force on 1 January 2022 through the adoption of the Climate Delegated Act[3]. Other climate related criteria are outlined in the Complementary Delegated Act[4]. The criteria for the remaining four environmental objectives have been drafted by the Platform on Sustainable Finance in March 2022 but they have not been yet adopted by the Commission.

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[1] ESG is a concept developed by the United Nations (UN) and stands for Environment, Social and Governance.

[2] Correlations between six prominent ESG rating agencies range between 0.38 and 0.71 as compared with the 0.92 correlation between credit rating agencies. Differences in measurement contributes 56% of the divergence. This result is based on data from 2014. "Aggregate confusion: The divergence of ESG ratings", MIT & University of Zurich, 2022 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3438533

[3] Commission Delegated Regulation (EU) 2021/2139 of 4 June 2021 supplementing Regulation (EU) 2020/852 of the European Parliament and of the Council by establishing the technical screening criteria for determining the conditions under which an economic activity qualifies as contributing substantially to climate change mitigation or climate change adaptation and for determining whether that economic activity causes no significant harm to any of the other environmental objectives (Text with EEA relevance). Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32021R2139

[4] European Commission (2 February 2022). "EU taxonomy: Complementary Delegated Act to accelerate decarbonization". Available at https://ec.europa.eu/commission/presscorner/detail/en/ip_22_711

From 2022, companies and financial market participants must report on the “eligibility” of their activities, that is to what extent their economic activities were covered by the Taxonomy in the preceding year. From 2023 the covered entities that have eligible activities will have to report on the “alignment” of such activities with the Taxonomy. Financial market participants will start to report one year later, since they will rely on the data from the non-financial companies.

However, even at this early stage the impact of the Taxonomy on the market is visible. Many undertakings have already begun voluntary reporting based on the Taxonomy. Even if such reporting outcomes at this stage are highly imperfect[5], the market displays a significant interest in the “Taxonomy related” assets[6]. This interest could be attributed to the obligatory reporting based on the Taxonomy as well as to the “political weight” of classification created by the public institutions. This combination generates demand for the Taxonomy aligned assets on the financial market. But it is worth exploring how it could perform in delivering the declared objective of the Taxonomy, that is involving the capital in financing the sustainable transition.

2.1. The “binary” nature of the Taxonomy

The regulatory nature of the Taxonomy is reflected by the fear of its “binary” interpretation, i.e. that activities which cannot be classified as sustainable are harmful. Those who need access to resources financing the transition are afraid of impact of such reading on the availability and the cost of capital as well as of reputational damages. The messages sent by many markets players who declare adoption of the Taxonomy as a guidance for their investment portfolio add to this anxiety[7]. The impact of such decisions can be very significant, especially in times when the investments are often driven by pre-programmed algorithms which are triggered by falling in or out of specific benchmarks.

This is reinforced by the fact that the EU Taxonomy formulates demanding criteria which very likely will allow only a small percentage of the economic activities in the EU to be labelled as “green”[8].

Some sectors are also concerned by absence of criteria for their activities, which might add to the confusion of users of the Taxonomy reports.

2.2. Challenges related to reporting under the Taxonomy

The financial and non-financial users of taxonomy agree on one aspect: reporting based on the Taxonomy generates many challenges.

First, it requires entirely a new set of data, previously unreported and not readily available[9].

Secondly, the environmental contribution to meeting the Paris Agreement’s objectives described by the Taxonomy’s criteria is not based on sectoral standards, but on the set of generic economic activities attempting to capture the economy by the “one-size-fits-all” approach.

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[5] Due to the reporting uncertainties described below and the fact that the DNSH criteria and minimum safeguards are usually omitted

[6] Goldman Sachs (2022). Progress on the Journey to Alignment. Available at https://www.goldmansachs.com/insights/pages/gs-research/eu-taxonomy-progress-on-the-journey-to-alignment/report.pdf

[7] Several net zero investment alliances declare adoption of the Taxonomy as a guidance tool for their portfolio and public financial institutions are drawing on the Taxonomy when identifying sustainable assets or clients, e.g. for taxonomy-aligned loan, investments or guarantee products [adelphi (2021). European Sustainable Finance Survey 2021: Public financial Institutions and the EU Taxonomy. Available at https://sustainablefinancesurvey.de/survey-2021#Downloads]

[8] According to early estimations made by Goldman Sachs, only 11% of assessed companies will have revenue exceeding 5% which will be potentially aligned with the Taxonomy criteria [Goldman Sachs (2022). Progress on the Journey to Alignment. Available at https://www.goldmansachs.com/insights/pages/gs-research/eu-taxonomy-progress-on-the-journey-to-alignment/report.pdf]. Also, in its survey from 2020, adelphi estimated that only 13% of analysed companies have an alignment level equal to or above 5%, while the remaining ones have an alignment level equal to or lower than 1% [adelphi (2020). European Sustainable Finance Survey 2020. Available at https://sustainablefinancesurvey.de/survey-2020]

[9] For example, the significant part of banks’ credit portfolio are general loans which cannot be easily connected with revenues, capital, and operational expenditure of companies; availability of data can also vary from sector to sector, especially related to “do no significant harm” criteria.

Third, the criteria are often complex and lack clear definitions.

Fourth, the criteria will change over time making the reporting exercise a moving target.

This makes reporting a challenge and will not necessarily produce uniform and representative results in terms of providing a common and comparable "sustainability image" of reporting businesses. Such a risk is clear at least in the short- and mid-term, that is the period in which the need of financing the transformation is most urgent.

2.3. Expansion of sustainable reporting obligations

The obligation to disclose the Taxonomy alignment applies to large undertakings covered by the duty of non-financial reporting[10] and financial market participants. However, despite political declarations that SMEs are exempted from the Taxonomy, they will be gradually becoming subject to its requirements.

First, since 2026 the obligation to report under the Taxonomy will be extended to listed SMEs.

Secondly, all SMEs will be under pressure to voluntarily declare their Taxonomy alignment because banks will be required to provide this information due to obligations resulting from the European Bank Authority standards[11].

Thirdly, many large companies will see "decarbonization" and "sustainability" as a ticket to trade for their suppliers and business partners; this may result also in exerting the pressure on SMEs to disclose their Taxonomy alignment.

In addition to the obligatory reporting under the Taxonomy[12], there is an ongoing expansion of other sustainability reporting requirements. Some of them have very close links with the Taxonomy.

The Sustainable Finance Disclosure Regulation (SFDR)

The Sustainable Finance Disclosure Regulation[13] (SFDR) was adopted in late 2019 and applies to financial market participants and financial advisers, which are required to disclose entity and product level information related to sustainability. Specifically, SFDR was amended by the Taxonomy Regulation in 2020 and now requires compliance with the Taxonomy-related concepts, such as the DNSH principle and minimum safeguards, and asks for identification of the Taxonomy's environmental objectives to which the financial products contribute. Moreover, the designated European Supervisory Authorities (ESAs) drafted the SFDR-related regulatory technical standards (RTS) to further specify the content, methodologies, and presentation of information to be provided pursuant to the SFDR based on the Taxonomy[14]. Their application will start from 1 January 2023.

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[10] As defined by Non-Financial Reporting Directive (NFRD), that is large public-interest companies with more than 500 employees, financial market participants (banks, insurance, asset managers) and their entities designated as such by Member states. This coverage will be extended by the CSRD to all large and listed companies – see below. [Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups Text with EEA relevance. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32021R2139].

[11] EBA (24 January 2022). Final draft report implementing technical standards on prudential disclosures on ESG risks in accordance with Article 449a CRR. EBA/ITS/2022/01. Available at https://www.eba.europa.eu/eba-publishes-binding-standards-pillar-3-disclosures-esg-risks

[12] Reporting under the Taxonomy is regulated in the Art. 8 of the Taxonomy regulation and in the Art. 8 Delegated Act

[13] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (Text with EEA relevance). Available at: https://eur-lex.europa.eu/eli/reg/2019/2088/oj

[14] This Delegated Regulation, also known as SFDR Level 2, was adopted by the Commission on 6 April 2022 and based its standards on the Taxonomy.

The Corporate Social Responsibility Directive (CSRD)

The new Corporate Social Responsibility Directive (CSRD) once formally adopted, will amend the existing regulations on non-financial reporting of large corporations (NFRD). This proposal introduces obligatory and detailed reporting on how undertakings impact the sustainability issues (that is environment, human rights, social standards, and work ethics) and how sustainability impacts them – this is the concept known as double materiality[15]. It expands the previous coverage of the NFRD to include all large[16] and all listed companies - including listed SMEs, for which it will start to apply two years later, in 2026. Changing the scope of application will increase the number of reporting companies from 11.000 to ca. 50.000[17]. This will also extend the coverage of the Taxonomy to the same category of entities[18]. However, the link between the CSRD and the Taxonomy will go deeper. For example, companies will have to provide explanation of the role of Taxonomy-aligned activities in their transition plan. Also, the CSRD refers to the Taxonomy in performance measurements of environmental objectives and the social part of reporting should be coherent with the requirement of minimum safeguards of the Taxonomy[19].

The Corporate Sustainability Due Diligence Directive (CSDDD)

The proposal for the Corporate Sustainability Due Diligence Directive (CSDDD) is intended to complement the SFDR and the CSRD with respect to due diligence policies of businesses related to impact on human rights and environment. It will apply to large companies based in the EU and outside the EU (12,800 and 4,000, respectively[20]). SMEs will be impacted being part of the value chains, as the Directive will apply to company's own operations, their subsidiaries, and their direct and indirect business relationships.

The Taxonomy Regulation already requires the alignment with minimum safeguards, that is the standards established by the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights. The concept of the social Taxonomy introduced by the Taxonomy Regulation, if implemented, might in the future expand the reporting requirements in this area and it will inevitably interact with the CSDDD requirements.

This list of above-mentioned sustainability reporting obligations is not exhaustive[21]. This burden will generate a significant challenge for businesses and will affect not only large corporations. Between those legal acts there are cross-references to the Taxonomy which makes all inter-connected. At the same time, it remains to be seen if such a matrix of reporting requirements will produce a fair, understandable, comparable, and credible result, which will guide investors in directing capital where it is needed the most, that is for the sustainable transition. ERCST will return with further analysis on this subject.

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[15] https://www.europarl.europa.eu/news/en/press-room/20220620IPR33413/new-social-and-environmental-reporting-rules-for-large-companies

[16] Employing more than 250 persons and having turnover of 40 million EUR or more.

[17] European Commission (2021). Impact assessment accompanying the document "Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/34/EU, Directive 2044/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting (Commission staff working document). SWD (2021) 150 final. Available at https://eur-lex.europa.eu/legal-content/PT/TXT/?uri=CELEX:52021SC0150

[18] It is so because the CSRD will amend Article 19a and 29a of the Accounting Directive (Directive 2013/34/EU), which define the scope of application the Taxonomy.

[19] See draft ESRS from EFRAG, available at https://www.efrag.org/Activities/2105191406363055/Sustainability-reporting-standards-interim-draft

[20] European Commission (n.d.). Corporate sustainability due diligence. Available at https://ec.europa.eu/info/business-economy-euro/doing-business-eu/corporate-sustainability-due-diligence_en

[21] Art. 8 Delegated Act to the Taxonomy Regulation, CSRD and CSDD introduce the requirement to prepare transition plans for undertakings.

2.4. *The policy spillover*

Nevertheless, even at this early stage, the Taxonomy spillovers to other policies, becoming a default reference for several EU strategies, e.g. on chemicals, steel, agriculture, textiles, etc. There are many other examples of this phenomenon.

The European Investment Bank in 2020 committed to aligning its lending policy with the Taxonomy framework and the EU Green Bond Standard, which will also incorporate the Taxonomy criteria. In sectors which are not yet covered by the Taxonomy, the EIB uses definitions within the spirit and logic of the Taxonomy. The most recent update of the EIB environmental sustainability methodology incorporated the criteria outlined in the first Climate Delegated Act.

The EU set an overall target of at least 30% of the total EU budget and the Next Generation EU in support of climate goals. This spending must be in line with "do no harm" principle derived from the Taxonomy.

The implementation of this principle can be found in the Regulation establishing the Recovery and Resilience Facility (RRF). It provides that reform and investment included in a Member State's Recovery and Resilience Plan (RRP) should not lead to significant harm to any of the six environmental objectives within the meaning of Article 17 of the Taxonomy Regulation[22].

The Markets in Financial Instruments Directive (MiFID) is the main legal act ruling the financial markets in the EU. It is currently under revision and the amendments mention the Taxonomy as an instrument guiding clients of financial markets in their preferences for sustainable investments.

Also, the Taxonomy alignment allows tax preferences in Luxemburg, which is home to 28% of global ESG assets. This is the direct financial incentive to follow the Taxonomy which may be copied by other jurisdictions.

However, the impact of the Taxonomy can be less visible, but still significant. For example, although the definition of low-carbon hydrogen in the Hydrogen and Decarbonized Gas Package is not complete, its parameters outlined in the draft Directive closely resemble the construction and thresholds from the Taxonomy Climate Delegated Act[23].

Most recently, the EU Council in its general approach to the revision of the ETS in principle excludes the possibility to finance energy facilities using fossil fuels by the Modernisation Fund. The exceptions to this rule are narrowly defined, limited in time, and confined only to activities fulfilling the "green" criteria of the Taxonomy.

In summary, the Taxonomy will probably cover a very small part of the European economy but will generate a significant challenge for businesses in terms of reporting, it may cause reputational damages and might produce not necessarily full picture of sustainability of businesses. Its effectiveness in directing money to finance the transition at this stage is uncertain, as a Taxonomy label attracts investors towards few best "green" performers, and not necessarily to those who need funding for green transformation. At the same time, the Taxonomy has a big political impact, shapes the EU and Member States policies as well as the financial market demand.

[22] https://ec.europa.eu/info/sites/default/files/c2021_1054_en.pdf

[23] The Hydrogen and Decarbonized Gas Directive refers to "hydrogen the energy content of which meets a greenhouse gas emission reduction threshold of 70% (Art. 1.10). Taxonomy Climate Delegated Act states that "hydrogen production is considered sustainable when the life cycle GHG emissions savings requirement of 73,4 % (resulting in life cycle GHG emissions lower than 3 $tCO_2e/H2$) and of 70% for hydrogen-based synthetic fuels relative to a fossil fuel comparator of 94 g CO_2e/MJ".

3. Extension of the Taxonomy: is it a way forward?

In March 2022 the Platform on Sustainable Finance, the advisory body advising the European Commission, issued a report in which it proposed to extend the Taxonomy beyond the green colour and add new categories of activities: always significantly harmful (always red), significantly harmful (red), intermediate (amber) and neutral[24].

It is presented as a way of breaking dichotomy of the Taxonomy by adding an intermediate performance (amber) category and, therefore, by introducing more nuance about the environmental performance of companies. Describing different levels of transition is supposed to be a guidance for undertakings and investors in defining activities which need to be transformed and require financing (red and amber), as well as those, which should be phased out (always red). A low environmental impact (neutral) category would address the fact that a large part of economic activities cannot be attributed an environmental significance. Such activities should be distinguished from those having an impact on environment to avoid misinterpretation of the performance of reporting undertakings, especially unfavorable comparisons to green categorization.

The concept of extension to a harmful, low impact and social category (the last one has been addressed by the PSF in the separate report[25)] is foreseen in the Taxonomy regulation. Although the intermediate category is not part of the current Taxonomy legal framework, the Platform encourages the market participants to start voluntary reporting prioritizing three categories: significantly harmful, always harmful, and intermediate performance. It argues that it can be done by using the current framework, namely the screening and the "Do No Significant Harm" criteria being already defined and in force. The "significantly harmful" or "red" category would describe activities not fulfilling DNSH criteria. The "intermediate" or "amber" category would contain activities fulfilling the DNSH criteria but not meeting the green criteria.

In principle, introducing the intermediate performance category has its merits: it would cover the biggest part of the economy, the one most in need to transform and, therefore, requiring financing. Arguably, this extension aims at expanding the role of the Taxonomy in the transition phase and at providing a more inclusive instrument. But this leap brings several risks.

First, it would add to the reporting complexity and challenges known from implementing just one category.

Second, the level of applicability of the Taxonomy criteria is still unclear and, therefore, it is uncertain if adding new categories will produce a meaningful sustainability image of reporting undertakings.

Third, the significantly harmful category would deepen the reputational risks and might undermine access to financing for undertakings which want to transform. This disadvantage is especially relevant vis-à-vis non-EU companies and jurisdictions.

Finally, this category may not reflect the rapid development of decarbonization technologies.

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[24] It is referred to as "the traffic lights taxonomy". The "always harmful" category describes activities which cannot improve environmentally and need to be phased out.

[25]https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/280222-sustainable-finance-platform-finance-report-social-taxonomy.pdf

4. Conclusion and recommendations

The Taxonomy being a classification tool used for obligatory reporting is difficult to ignore. However, it risks becoming an instrument of limited scope but with big and not necessarily desired impact due to its demanding thresholds, expected low alignment, one-size-fits-all approach, criteria open for interpretation, the fact that they were designed with little participation of sectoral market participants, and problems with data availability. Being a complex exercise for reporting entities, the Taxonomy oversimplifies the sustainability image of undertakings by presenting an environmental performance of businesses based only on three parameters (CapEx, OpEx, revenue). This is not necessarily sufficient for making informed investment judgments and business decisions.

Investors admittedly want to understand the actual impact of climate- and environment-related issues on businesses' strategy, and vice versa. But effective disclosure should be grounded in narrative of qualitative information to help users to understand the context. The market has developed tools which are instrumental in defining the environmental performance of businesses and net-zero transition plans. Those tools use the Paris Agreement ambition as a target and the science-based methodology for setting benchmarks – similarly as the Taxonomy[26]. A standardization and comparability are in demand, and the market presents many initiatives aiming at convergence of reporting tools and metrics[27]. Given the pitfalls related to the Taxonomy discussed above, it remains to be seen, rather in mid- and long term, if it can deliver on this front. Despite those doubts, it becomes the main point of reference in defining "sustainability" in other EU policies.

One of the key challenges stemming from the EU Green Deal agenda is ensuring financing of the transition towards the climate neutral economy. The Taxonomy has been promoted as a tool to support this effort. Although the main burden and consequences of its application lie on the non-financial organizations, the Taxonomy as it stands may end up serving the financial players in marketing the premium "green" products.

Considering the expected low Taxonomy alignment, the flow of capital towards the transition will likely be ensured by instruments other than the Taxonomy. When lending money or investing, the banks and the investors increasingly expect from undertakings the strategy addressing climate-related risks and transition plans. Such plans are designed in cooperation between market players (financial sector, industry), are based on scientific approach and are aligned with the Paris Agreement objectives. They build on industrial standards, are related to the company's business strategy, and reflect the individual situation of an organization. Therefore, they better reflect the undertakings pathway to net-zero and give much more sophisticated guidance to lenders, investors and to the public.

The Platform on Sustainable Finance proposes the extension to categories other than "green" to address some of the criticism pointed at the Taxonomy, in particular its dichotomy. In principle we see the merit in addressing the economic activities of intermediate environmental performers: they will need financing most and represent the largest share of economy. But we also note the risks in extending the Taxonomy at this stage, especially by adding to the reporting complexity and challenge.

Therefore, the decision concerning the extension of Taxonomy could be taken only after the green Taxonomy is put into practice, and its applicability, impact and usefulness are known. Hence, the priority now should be to support organizations in their implementation efforts, accompanied by the proper public narrative counteracting its binary interpretation. Until then, utmost prudence and caution is advised when using the Taxonomy for other policies and purposes.

[26] For example, Transition Pathway Initiative or Net Zero Company Benchmark Indicators.
[27] See Task Force on Climate Financial Disclosures, available at https://www.fsb-tcfd.org/publications/

The process of adoption of criteria shows the risks associated with the Taxonomy designed as a regulation which serves too many purposes. It consumes a lot of political capital and resources and introduces a lot of uncertainty on the market. The politics around classification of nuclear energy and gas effectively put on hold the process of implementation of the Taxonomy[28]. It delayed the adoption of the criteria for remaining four environmental objectives and the criteria for activities, which had not been yet covered. Catching up on this front should be another priority now. It is too late to make the politics around Taxonomy disappear, but the lesson learnt is that in policy making the old Latin wisdom remains true: "whatever you do, do it wisely and consider the end."

[28] See the ERCST note on inclusion of nuclear energy and gas to the Taxonomy, available at https://ercst.org/ercst-reflection-note-gas-and-nuclear-energy-in-the-eu-taxonomy/