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The EU economic transition challenge

EU SUSTAINABLE FINANCE AND TAXONOMY DEVELOPMENTS: IMPLICATIONS FOR THE ECONOMIC TRANSITION AND IMPACTS ON OTHER POLICIES

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1. The Sustainable Finance Strategies of the European Commission

ERCST Sustainable Finance (SF) workstream acknowledged the publication, in 2018, of the SF strategy by the European Commission (EC). This document identified three strategic objectives for the EU SF:

- **reorienting capital flows** towards sustainable investments
- **managing financial risks** stemming from climate change and environmental degradation
- **fostering transparency and a long-term approach** in financial and economic activity.

To achieve these objectives, the SF strategy included 10 key action points. Since ERCST mainly deals with policy issues related to carbon markets and corporate strategies, we identified the following 4 action points as key issues to be further analysed:

- #1 (EU Taxonomy)
- #2 (European Green Bond Standard and EU Ecolabel)
- #9 (Corporate sustainability disclosure, i.e.: Corporate Sustainability Reporting Directive & Sustainable Finance Disclosure Regulation)
- #10 (Corporate governance)[1]

In July 2021, a renewed SF strategy was published by the EC. An effort was made for the establishment of a more comprehensive framework. Indeed, the idea of intermediary steps toward sustainability was introduced, as well as the intention to propose legislation on supporting transition finance.

2. The EU Taxonomy: a broad policy perspective

The EU Taxonomy is considered by many as the flagship initiative on SF at EU level. ERCST therefore decided to start its policy analysis with a deep dive on the EU Taxonomy Regulation, bringing a broad perspective to the current policy debate and questioning its overall impact on the EU economy and policy making[2]. The EU Taxonomy has been presented by EU legislators as a disclosure tool, and a broad range of stakeholders (including companies) are welcoming such initiative in principle, being more critical on its technical developments rather than to the approach itself of creating a list of green thresholds for activities.

However, such Regulation can also be assessed on the base of its pervasiveness to the EU economy: the structure of this list and the choice of which activities should and should not be included will inevitably send market signals conceived with a top-down approach. This represents a shift of the EU balance between market and regulation towards a more centralized economy. ERCST wants to consider not only the EU Taxonomy short-term impact, but also its medium-long one, and a right long-term consideration is whether this approach will incentivize the EU decarbonisation in an efficient way, creating the right market tools for identifying the most efficient technological pathways to reach climate neutrality by 2050.

Moreover, considerations should be made on which role the EU Taxonomy should and should not play in the transition (is it a disclosure tool or a market driving one?) and whether it is suitable

[1] The initiative mainly aims at ensuring that sustainability is further embedded into the corporate governance framework with a view to align better the long-terms interests of management, shareholders, stakeholders, and society

[2] The key question is: are climate change and sustainable finance policies having a correct interplay and an efficient impact in decarbonizing the EU?

for the non-financial sectors of the EU economy. In short: how to make the best out of the EU Taxonomy? To answer this question, a focus on making smart use of the EU markets and competition represents a crucial exercise, also for meeting the EU environmental goals without losing international competitiveness. For example: could an expansion of the EU ETS in sectors with high enough price elasticity of demand be a better alternative for incentivizing the process of lowering emissions, whilst letting the market actors assess the sectors with the more convenient abetment costs?

These and similar considerations regarding the nature of the EU Taxonomy approach are at the core of ERCST initial analysis of the EU SF package.

3. The EU Taxonomy issues and the economic "transition challenge" of the non-financial corporates

On top of the general interventionist approach of the EU Taxonomy, ERCST also identified a specific issue in its initial design, failing to incentivize non-financial corporates to start navigating the decarbonisation process. Indeed, its current structure fails to flexibly measure the intermediary steps at entity level, usually setting only the end point at activity level in a piece of paper, without assessing the feasibility, cost-effectiveness and risk return ratio to reach it[3].

In this context, ERCST identified the economic "transition challenge" as the main issue to be analysed in the SF field. With "transition challenge", ERCST refers to the challenge that the EU economy is facing and will face in the coming decades to plan and meet climate neutrality by 2050 in a sustainable way. For better analysing the EU Taxonomy Regulation in such context and provide suggestions to the EU and global policy debate, ERCST identified three main questions to be tackled:

- **Q1: How to better define the EU Taxonomy's scope in the context of the EU economic transition challenge?**
- **Q2: What is the EU Taxonomy impact on other policies?**
- **Q3: How to make the EU taxonomy an international tool?**

4. The ERCST survey

To further analyse the impacts of the EU Taxonomy on the balance between markets and regulation, and to beef up the analysis on the first two questions, ERCST also conducted a survey throughout the summer 2021, collecting information on the "sentiment" around these issues from a broad range of actors.

Notably, the survey has a first section dedicated to the navigation of the transition, its design and financing (touching upon the "role" of the EU Taxonomy as a tool for supporting the transition, its extension to "Significantly Harmful" and "No Significant Impact" activities, economic costs and restructuring needs related to its implementation, role of transition pathways) and a second one dedicated to the EU Taxonomy interactions with other policies (notably with sustainable finance legislation and the "Fit for 55" package).

For our survey, we consulted several selected experts on international and EU sustainable finance (29% policy makers and governments; 25% business associations; 17% non-financial undertakings; 12% think tanks or academic institutions; 10% NGOs; 7% "Other"). Among

[3] Taxonomy, as it stands, is a mere labelling and disclosure tool, mainly designed for financial actors rather than non-financial undertakings

associations and undertakings, there was broad sectoral coverage (mining; oil & gas; chemicals; manufacturing; transport; electricity; banking / insurance / asset managers).

4.1. "How to better define the EU Taxonomy's scope"

Stakeholders, in the survey, generally agreed on the role of the EU Taxonomy to design and finance the economic transition (78% agree or strongly agree). Hesitations seems however to remain on its increasingly detailed and prescriptive approach (32% of stakeholders do not support an extended EU Taxonomy).

The EU Platform on SF designed a conceptual framework for the extension to "No Significant Impact" (NSI) and "Significantly Harmful" (SH) activities[4]. Indeed, we can have three kinds of SH activities: one able to reach "substantial contribution" (SC) levels, one able to reach intermediate level, and one unable to stop being SH. This automatically create a framework with an intermediate transition (from SH to intermediate) and a green transition (from SH to SC and from intermediate to SC), with an improvement remaining within intermediate level to be further defined.

Regarding the EU Taxonomy's scope in the context of transition and its possible extension to identify non-green activities (i.e., NSI and SH), ERCST identified – thanks to all the input collected – three initial "takeaways".

4.1.1. EU Taxonomy must not be seen as the only tool for designing and financing the transition

As already mentioned, the EU Taxonomy was not solely designed for the economic transition challenge, but with a (mostly financial) labelling intention, considering market transparency and symmetry of information needs. It can surely be shaped more accordingly, accounting for the economic transition challenge, but it will not be the silver bullet as bankable sustainable projects are not only shaped with transparency tools.

Therefore, it is timely and necessary to analyse and identify other transition instruments, as well as considering the current market bottlenecks for greening activities. Notably, ERCST identified two types of transition instruments: designing and financing tools.

As a designing tool, transition pathways have been generally accepted, by most stakeholders consulted for the survey, as crucial to navigate the transition; we will address this specific topic in the next session. Regarding the financing tools, ERCST analysed the general appetite for: traditional (& sustainability linked) bank loans; (thematic) equity investments & funds; green and transition bonds and debt investments; blended finance with a focus on the private sector (e.g.: public guarantee-based solutions such as InvestEU or credit risk guarantee instruments). There is broad consensus that they will all represent a crucial instrument.

4.1.2. Designing the transition: the transition pathways' role in the economic transition

As already mentioned, ERCST identified (sectoral) transition pathways as key tools for the transition, if backed by a robust and credible regulatory framework. The CSRD proposal represents a window of opportunity, as well as Article 10 of the EU Climate Law dedicated to

[4] The EU TR defines three performance levels: two explicitly (SC and SH) and one implicitly (intermediate). However, the EU TR does not define corresponding activities which would require Article 1 and 3 to be rewritten.

sectoral roadmaps. They moreover represent the possibility to solve the issue of the EU Taxonomy not being an entity level instrument. As a matter of fact, they could:

- support the shaping of an enabling, predictable, and bottom-up regulatory environment, thus ensuring regulatory stability; and
- make the transition more cost and risk efficient (profitability issue to be tackled), whilst involving a broader range of actors in their design.

4.1.3. EU Taxonomy extension to SH and NSI activities

ERCST supports the intention of the Commission to develop a more comprehensive framework for transition finance with the aim of recognizing transition efforts. However, the extension framework of the EU Taxonomy to "Significantly Harmful" (SH) and "No Significant Impact" (NSI)[5] activities should also consider the various reasons for a non-extension or a postponement of it[6], notably:

- Practicability and complexity issues and need for a phase-in approach for ensuring legal certainty,
- Too many nuances across transitional activities and types of transition for a general definition
- Creation of "stranded assets by legislation" and consequent increased transition risks
- Companies being already under market pressure for sustainability improvements, and therefore it would be better to strengthen the framework for CSRD and Article 8 transition plans
- EU vs non-EU competitiveness issue
- The departure from the positive spirit of the EU Taxonomy
- Strong interference with company's decision-making process, and risk of not focusing on creating a market based environment where companies are incentivized to enhance their sustainability performances

4.2. "What is the EU Taxonomy impact on other policies"

ERCST considers the analysis of EU Taxonomy's interactions with other policies an important issue because, among other things, such interactions will have an impact on the overall market functioning of the EU. ERCST reckons that the EU Taxonomy Regulation will have two main types of direct and indirect impacts:

- Firstly, on other Sustainable Finance (SF) policies.
- Secondly, on other environmental and climate policies, such as the ones included in the "*fit for 55"* package, as well as on public funding and aid schemes like the Recovery and Resilience Facility, the Cohesion policy, Invest EU, the revised Climate, Energy and Environmental Aid Guidelines (CEEAG), etc.

If the impact on other SF policies was previously considered by policy makers[7], the one on other policies is still difficult to be robustly analysed. ERCST has tried to create a first framework of analysis, also thanks to the input received from the survey.

[5] Platform on Sustainable Finance's draft report on taxonomy extension options linked to environmental objectives: https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/sustainable-finance-platform-report-taxonomy-extension-july2021_en.pdf
[6] The following considerations has been collected with desk research as well as via the ERCST survey
[7] COMMISSION STAFF WORKING DOCUMENT, IMPACT ASSESSMENT REPORT (2021): https://data.consilium.europa.eu/doc/document/ST-9801-2021-INIT/en/pdf?utm_source=Associate+Members&utm_campaign=4cc64ada7f-EMAIL_CAMPAIGN_2018_11_07_05_13_COPY_01&utm_medium=email&utm_term=0_00bf999edc-4cc64ada7f-246002533

4.2.1. The EU Taxonomy impacts on the Sustainable Finance (SF) policies

4.2.1.1. The EU Green Bond Standard (EU GBS)

According to the proposed EU Green Bond Standard (EU GBS) Regulation, the EU Taxonomy Technical Screening Criteria (TSC) defined in the climate delegated acts (DA) will be the reference for issuing an EU GBS (which is voluntary)[8].

The activities chosen for the DA and the TSC will therefore shape the financing mechanism of companies (and countries) that will intend to issue a green bond. This also opens a legitimate question regarding the adequacy of activities listed (and not listed) in the EU Taxonomy delegated acts: what is the rationale behind such decision?

Moreover, it is still unclear how "low-carbon" and "transitional" bonds will be defined at EU level, and if and how they will be linked to the EU Taxonomy Regulation. In general, even with this legal uncertainty regarding future developments, 63% of participants showed interest in potentially using the green bond.

4.2.1.2. The Corporate Sustainability Reporting Directive (CSRD); the Corporate Governance Initiative

The "legal" influence of the EU Taxonomy Regulation on the future CSRD stands in the TR Article 8, which requires companies under the scope of the CSRD to disclose the undertaking's taxonomy-alignment with: 1) Turnover; 2) Capex; & 3) Opex (i.e., disclosing information about companies' investment strategies). 39% stakeholders think there are overlaps, 31.5% do not know, 19.5% are neutral and 10% disagree.

On the other hand, EU Taxonomy "non-legal" influence will likely shape businesses' decision making and environmental risk management[9].

4.2.1.3. The Sustainable Finance Disclosure Regulation (SFDR)

The "do not significant harm" (DNSH) principle is present in both legislations, but SFRD definition of "sustainable investment" is broader and overarching (including also social aspects) whilst the EU Taxonomy goes into detail and requires a "substantial contribution" (and not only "contribution", as in the SFDR) to an environmental objective[10] (i.e.: not focusing on social aspects, so far). The two definitions therefore differ between each other, and which one will be considered by the market (i.e., financial, and non-financial companies) is still unclear.

4.2.2. The EU Taxonomy impacts on the "fit for 55" package (and on EU public funding)

From the survey, the conclusion is that there are lots of uncertainties among stakeholders regarding the future interactions with the package, mainly with the ETS, ETD, and the RRF. Below, ERCST makes initial consideration on selected number of policies.

4.2.2.1. The Emission Trading System

As any other policy intervention incentivizing the reduction of emissions (and thus the reduction of CO_2 demand within the ETS market), the effect of the EU Taxonomy will be to bring the price of carbon down.

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[8] Proposal for a regulation on European green bonds: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0391

[9] The results from the consultation on the Renewed Sustainable Finance Strategy indicate that a high degree of use can be expected at least among economic operators that consider themselves sustainable. Among these companies, two thirds indicated a high or very high likelihood of using the EU Taxonomy in business decisions

[10] Moreover, there are some *horizontal issues across EU policies in the definition of sustainability reporting (e.g., definition of "sustainable" & "green" differs between Taxonomy & SFDR. Moreover, there is a potential lack of coherence among CSRD, SFDR & Taxonomy regarding reporting obligation in line with the double materiality.*

Additionally, the EU Taxonomy will likely impact the technological neutrality principle of the EU ETS, with the risk of creating green bubbles with inefficient overallocations of capital on certain activities (and thus leading to inflated and unstable asset prices).

If the EU Taxonomy is not technology neutral, the industry will likely be incentivized to focus its investments strategies on mainly net-zero technologies, stopping some of the transformation (and maintenance) investments in the current hard-to-abate activities. This effect can leave certain EU markets at competitive disadvantage with productions from the rest of the world, making the EU industry lose its competitiveness in greening certain carbon intensive activities. This might therefore reduce investments in the new technologies. On the other hand, profits in the rest of the world will be used by industries to invest in R&D and industrialize the new technologies.

4.2.2.2. The Energy Taxation Directive (ETD)

The revised ETD will likely interact with the ETS[11] carbon leakage governance, increasing EU carbon leakage risks. Therefore, ERCST suggests considering the impacts on the most affected industries (also on the base of their trade exposure).

The proposed ETD, by considering both energy content and environmental impact in setting the tax rate, risks to introduce a double taxation system for certain products.

4.2.2.3. The Renewable Energy Directive (RED); The Energy Efficiency Directive (EED)

EU Taxonomy will likely reinforce the current (and proposed) RED objectives, increasing RES in the EU energy mix by removing barriers, stimulate investment and drive cost reductions in RES, as well as the current (and proposed) EED (improved energy efficiency) objectives.

4.2.2.4. The Recovery and Resilience Facility (RRF); the InvestEU Regulation

The DNSH principle was required to be included by all MSs designing their RRF plans, with a technical guidance document issued by the EU Commission, which is not in line with the TSC defined in the EU Taxonomy climate delegated act but followed *ad-hoc* principles, i.e., only the DNSH "principle" was exported and not the TSC. Also, InvestEU requires to be DNSH compliant. There is therefore the need to check consistency of the DNSH principle across legislations.

5. Initial considerations on the international uptake of the EU Taxonomy

The EU Commission expressed, in its renewed SF strategy, the aim to foster global ambition by developing international SF initiatives and standards, embracing the double materiality principle[12] as well as beefing up the role of the EU Taxonomy internationally.

Regardless of the overall issues previously mentioned by ERCST, we identified as the main contribution of the EU Taxonomy its ability to set clear principles in the regulation (environmental objectives to be met, SC, DNSH) which are exported to other jurisdictions. However, in view of ERCST, there are some areas that merit further discussion and may represent a problem for their uptake. We decided to structure them in three sections.

[11] Risk of double taxation between the EU ETS, which is seen as the main carbon pricing instrument at the European level, and the ETD, since ETD will likely be revised to tax fuels based on their carbon content

[12] LSE website: "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)."

- **Integrity**: risk of becoming a political exercise at MS level (current nuclear and gas debate at EU level) influencing the determination of energy mixes
- **Practicality**: EU Taxonomy is at activity level and therefore difficult to decline at entity level, in order to accommodate transition nuances of the EU economy. The EU Taxonomy was indeed designed for the financial corporates rather than non-financial corporates.
- **Market interactions**: 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 reduce the environmental impact whilst establishing markets where the green risk return ratio makes economic sense.

Historically, the US approach to finance gave preferences to principle-based elements without restrictive thresholds and with the aim of incentivise, when doable and possible, market-based approaches acting at systemic level in a technological neutral approach. Policy elements with a centrally planned flavour should always be accompanied by policy measures that intervene on the pricing mechanisms. In such way, private actors have more freedom to act in the regulatory framework and deal efficiently with environmental risks and opportunities and transition efforts. The understandable policy needs to prescriptively define the entire economic may indeed bring to more inefficient disadvantages in the decarbonisation process rather than advantages in the long term.

6. Next steps

ERCST intends to continue its research on:

- EU Taxonomy and transition finance: the role of sectoral transition pathways
- EU Taxonomy impact on other policies
- EU Taxonomy international developments

Specific elements of the survey will be further analysed in 2022, whilst organizing working groups with selected experts with the aim of producing discussion papers on the above topics.