EU Taxonomy – Technical Screening Criteria (Mitigation/Adaptation) Update

Sustainable Finance
and Responsible Investment

June 2021

Introduction

This briefing note reflects the content presented in a webinar by Chinyelu Oranefo recorded in June 2021 as part of the Loan Market Association's ("LMA") Talking Taxonomies series.

This also follows on from our Sustainable Finance April Update series.

This note considers the EU Taxonomy "Technical Screening Criteria" for Climate Mitigation and Climate Adaptation (the "TSC"), the implications of the finalisation of this Delegated Act in terms of the disclosure regulations, financial products and the loan market and what's next for Sustainable Finance.

Background

The EU's Taxonomy Regulation is part of the European Commission's Sustainable Finance Action Plan which in turn is part of a much wider growth strategy called the European Green Deal. The latter is targeted at transforming the EU's economy for a sustainable future with no net emissions of greenhouse gases by 2050. The deal has two limbs – firstly "financing the transition" and secondly ensuring it is a Just Transition "leaving no-one behind".

Key dates and figures

- The final report on the Taxonomy was published by the Technical Expert Group in March 2020 following two years of negotiations, drafting and consultations.

- The EU Platform on Sustainable Finance ("PSF") is the successor of the TEG and continues to advise the EC on sustainable finance issues. Most recently the PSF delivered its report on Transition Finance on 19 March 2021.

- The Taxonomy Regulation entered into force on 12 July 2020 and forms the basis of the "world's first "green list" for environmentally sustainable economic activities"

- The Taxonomy Regulation identifies six environmental objectives at least one of which an economic activity, must substantially contribute to in order to be classified as environmentally sustainable.

- The relevant activity must also:
  - "do no significant harm"
  - comply with minimum social safeguards
  - comply with the TSC

- The issue of the technical screening criteria has been long awaited and a draft was published for consultation in November 2020 and received 46,000 responses. Only the first two environmental objectives, being climate change mitigation (ensuring that "climate neutrality and limiting the increase in temperature to 1.5% degrees globally") and climate change adaptation ("implementation of solutions to substantially reduce the most significant identified climate risks e.g. wildfires, storms or droughts"), have had technical screening criteria developed for them so far.

- The Commission adopted the first Delegated Act enshrining the TSC on 21 April 2021 and its final adoption (or wholesale rejection) by the European Parliament will occur within 6 months with the Act becoming applicable from 1 January 2022.

If you want more background on any of those topics, please see our Sustainable Finance April Update Series.

The EU Taxonomy's technical screening criteria

The TSC sets thresholds and other relevant criteria for specific economic activities which are classified as environmentally sustainable. The finalised TSC is broadly similar to the draft circulated in November 2020 however significantly there have been some notable inclusions, exclusions and deferments.

What's in?
Bioenergy provided that it meets relevant criteria.

What's out?
Fossil Fuels such as **coal**.

What's deferred?
(to be dealt with by a complementary Delegated Act):

Agriculture
the Commission states that the role that this sector plays in both climate change mitigation and biodiversity loss and other sustainable development goals and on-going negotiations on the Common Agricultural Policy meant these technical specifications had to be delayed.

Nuclear
this was expected to be excluded outright on the basis that the activity does not comply the Do No Significant Harm principle; however the decision has been deferred pending the outcome of two independent reviews of a technical report on the environmental impacts of nuclear waste.

Natural gas and related technologies
as transitional activities provided they fall within the limits of the EU Taxonomy Regulation.

It will not be a surprise that the final position reached in the TSC has not been satisfactory to everyone. In fact the publication of Delegated Act triggered five NGOs to suspend their involvement in the process on the basis that they did not want to be seen as endorsing greenwashing in respects of particular activities. Nevertheless the EC is absolutely clear in its view that the performance thresholds are "*science-based*" and "*set sectors on a path consistent with the EU's climate and environmental goals based on currently available technologies*".

It's worth being clear on the fact that the targets set by the Taxonomy and TSC are, by definition, not easily achieved because they reflect a "substantial contribution" to meeting the EU's 2030 and 2050 zero carbon targets. As such they are more stringent than is required by current standards in order to encourage a shift in the economy and will be subject to review at least every three years.

The TSC cross references two Annexes which detail the actual specifications to be met in order to make a substantial contribution to climate change mitigation (Annex 1) and climate change adaptation (Annex 2) by economic activities ranging from forestry and transport to computer programming and creative, arts and education.

Transitional activities

Instead of taking a "green or not" approach, the Taxonomy recognises that certain activities do not yet have the necessary low-carbon technologies available to them, and in these cases, the "best-in-class" performance has been recognised provided that (a) low-carbon alternatives are not impeded by such activities and (b) no "lock-in" of carbon-intensive assets results from them. These "transitional activities" are defined in Article 10(2) and are activities which make a substantial contribution to climate change mitigation by supporting the transition. It is anticipated that the technology thresholds for these activities will also tighten over time.

Climate Change Mitigation (Annex 1)

Activities may qualify because they are deemed to be:

(a) "**green**" – zero or very low carbon emission and carbon sequestration e.g. renewable energy, zero carbon transport;

(b) "**transitional**" – in transition to low carbon economy e.g. efficient manufacturing (being top 10% performance) of iron, steel, hydrogen and electricity production from renewable gas where the carbon produced is captured and stored – these thresholds will reduce and be phased out over time; or

(c) "**enabling**" – enable climate change mitigation to take place e.g. construction and civil engineering works or installation or manufacture of energy efficiency equipment or renewable energy plant.

Climate Change Adaptation (Annex 2)

This criteria can apply to all sectors and activities which need to ensure they are resilient to climate change. These activities will "contribute substantially to reduction of the negative effects of current and expected future climate change". To qualify the activity will, amongst other things, need to be confirmed by a climate risk and vulnerability assessment that the relevant solution reduces the most significant physical climate risks relevant to that activity. It is possible that one activity may qualify under both annexures.

Real Estate examples

Mitigation

— **Acquisition and Ownership of Real Estate** – Pre 2021 buildings with an Energy Performance Certificate "A" rating or falling within the top 15% of local stock as measured by Primary Energy Demand will qualify as "green". This aligns with the standards set by the Climate Bonds Initiative and will also form the basis of the EU's green bond standard.

— **New buildings** – must receive an Energy Performance Certificate confirming that energy performance is at least 10% lower than the threshold set for Nearly Zero Energy Building requirements.

— In terms of the Do No Significant Harm ("DNSH") criteria, the TSC set out the additional standards to be met in order for the activity:

  – not to harm the "sustainable use and protection of water" by reference to maximum water flow rates

  – account for a circular economy – 70% of demolition waste needs to be prepared for recycling

  – protect and restore biodiversity ecosystems e.g. the new construction cannot be built on arable land or land recognised as having high biodiversity value

— **The renovation of an existing building** – must result in an improvement of primary energy demand of at least 30%

Adaptation

— Looking at the same activities in Annex 2:

  – These must substantially "reduce the most important physical climate risks that are material to that activity".

  – An Assessment must be undertaken which screens the activity by reference to physical climate risk and the solution must not (a) adversely affect other climate risks for others, and (b) must not favour nature-based solutions.

  – The DNSH criteria requires that the building can not be used in connection with the fossil fuel industry.

  – At least EPC C (pre 2021) or top 30% of local real estate stock otherwise must apply to the property.

Coverage

Current estimates indicate that the EU Taxonomy criteria cover economic activities of 40% of listed companies and 80% of direct greenhouse gas emissions in Europe; however research suggests that there is only currently between 1-5% alignment with the Taxonomy generally across the European economy. The European Banking Authority estimates that 8% of EU bank assets are taxonomy-aligned and up to 60% of its financing exposure sits in transition risk sectors of which 35% is particularly sensitive to transition policies e.g. carbon taxes. The EBA conducted its research in the context of upcoming disclosure requirements for private banks and their green asset ratio which is determined applying the EU Taxonomy.

Implications

The EU Taxonomy and Delegated Acts sit within a broader sustainable finance or "Taxonomy framework" which includes the Non-Financial Reporting Directive (NFRD) and the Sustainable Finance Disclosure Regulation and an EU Green Bond Standard which is yet to be tabled. For further details on these regimes please refer to our previous briefings in the Sustainable Finance April Update series.

NFRD/CSRD

The NFRD was adopted in 2014 and introduced a requirement for companies to report on material sustainability issues as they affect their business and as the companies impact on the environment and people (the "double materiality" approach). The reporting that has been done since the regulation came into effect in 2018 has been deemed insufficient so it is currently being proposed to expand the scope of the regulation by way of the Corporate Sustainability Reporting Directive (CSRD) in order to create a "comprehensive corporate reporting framework" within which large and listed companies can articulate their sustainability risk.

The CSRD increases the scope of the NFRD to large companies (having more than 500 employees) in addition to the already covered public interest entities (listed companies, banks and insurance companies).

The CSRD incorporates the EU Taxonomy by reference and companies will be required to report on their environmental performance and any Taxonomy-aligned economic activities. The CSRD requires reporting on a broad number of environmental performance indicators i.e. turnover, capital expenditures and operational expenditure around the impact of their business on the climate, the impact of climate change on their business and it is not limited to Taxonomy alignment. Obviously just because an activity does not comply with the Taxonomy requirements i.e. does not make a "substantial contribution" to the climate change mitigation, it does not necessarily mean that it or the company that pursues it is "bad".

The CSRD proposals include a requirement that all sustainability reporting is subject to audit or some alternative "assurance" by third party providers.

Mandatory reporting under the CSRD commences from January 2022 and it is also proposed that the scope of the CSRD is expanded to listed SMEs from 2026 but the reporting standards may be simplified for them in order to reduce the reporting and economic burden.

SFDR

Secondly the Sustainable Finance Disclosure Regulation (SFDR) became applicable on 10 March 2021 and requires sustainability disclosure by financial market participants (e.g. asset managers and financial advisers) to investors and asset owners in respect of financial products and financial entities. Again, both Taxonomy compliant and non-compliant financial products must be identified and information provided in respect of the firm itself and an analysis of sustainability risk and relevant strategies. In theory the disclosures made by these financial market participants will be gleaned from the NRFD and CSRD disclosures as well as being available to everyone generally.

Sustainable Finance

The EU hopes that companies (financial or otherwise) will use the EU Taxonomy to "plan their climate and environmental transition… or design credible green financial products".

As we're seeing with the consultations undertaken by the LMA in relation to sustainability linked loans, there is a real concern about products with specific performance targets which aren't sufficiently ambitious or can't be objectively verified so the Taxonomy by virtue of it's input into European benchmarks is going to be relevant.

The development of SLLs seems to be critical in light of the fact that most financial products provided to companies are for general purpose lending.

Benchmarks

Green standards and labels such as the EU Green Bond Standard and the EU Climate Benchmarks Regulation are also to be brought into line with the EU Taxonomy. As already mentioned, in the case of real estate, the Taxonomy standards the TSC conforms with are the standards set by the Climate Bonds Initiative. We know that the bond market standards have been ahead of, and very influential on, the loan market development of sustainability products so we could see that this becomes the market standard approach for green loans in the real estate sector.

European Banking Authority / Central Banks

At a recent conference the head of Germany's central bank supported the "decarbonising" of ECB monetary policy. Elsewhere there are calls that the ECB should only hold securities if issuers are "meeting climate-related reporting obligations" – we think that this means that there would be less inclination to acquire assets from those faring less well in the transition process. In the UK, there have now been several speeches indicating that pressure can be expected on financial institutions to take responsibility for their "financed emissions".

Financial Institutions

Disclosure – With the implementation of the disclosure regulation and here in the UK, the TCFD reporting regimes, banks are increasingly grappling with how to find the necessary data to report on, and gaining an awareness of where they themselves are positioned, in terms of climate change risk.

Back office/front office

It is yet to be seen how the broad climate related disclosures that banks and other financial institutions are having to make will influence the nature of the sustainability products they create; however to my mind there must be a link between investors desiring more demonstrable sustainable investments and the increasing demand from borrowers for loans with sustainability accreditation. Furthermore we can expect an impact on the cost of and need for capital, not just merely arising from central bank regulation but also from rising costs due to carbon taxes and fossil fuel subsidy cuts, etc. This will drive the cost of, and need for, lending and consequently make lending to Taxonomy compliant activities more attractive.

Refinancing Risk

Lastly, we are hearing sounds in the market to the effect that certain financiers are beginning to consider what degree of refinancing risk a borrower poses in terms of their ESG performance.

Whether you agree with those opinions or not the direction and momentum of change is undeniable, as demonstrated by the recent manoeuvre by activists to secure more "climate-friendly" directors on the board of ExxonMobil. Institutional Investors are increasingly talking in terms of the "stewardship" of their investee companies towards transition or net zero compliance in the anticipation of climate-risk being priced into the market.

Next Steps

In addition to the various forthcoming initiatives e.g. green bond framework, benchmarks and central bank requirements, mentioned above, you should be looking out for the following in the Sustainable Finance space:

Remaining Delegated Acts

— We understand that consultations will take place to address activities making a substantial contribution to the four remaining environmental objectives this summer. Draft TSC will be prepared by the Platform on Sustainable Finance for consideration by the Commission and are expected to be published by the end of 2021.

— It is expected that by the end of 2021 we'll also know whether the Taxonomy Regulation could be expanded to cover other matters such as social objectives.

— All the Delegated Acts will be updated and expanded over time.

UK Taxonomy

As we've discussed in other briefings, the UK is due to have its own taxonomy which will be inspired by the EU version but tailored to the UK's needs. The latest news on this is that the Green Technical Advisory Group has been established and will be chaired by the Green Finance Institute. This is still expected in by the end of 2021.

International Platform on Sustainable Finance

This is co-chaired by China and the EU and is working on a review of all existing taxonomies in order to produce a Common Ground Taxonomy which in due course is intended to form the foundation for a common global standard. Interestingly the People's Bank of China is reported to have confirmed its support of the EU Taxonomy.

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