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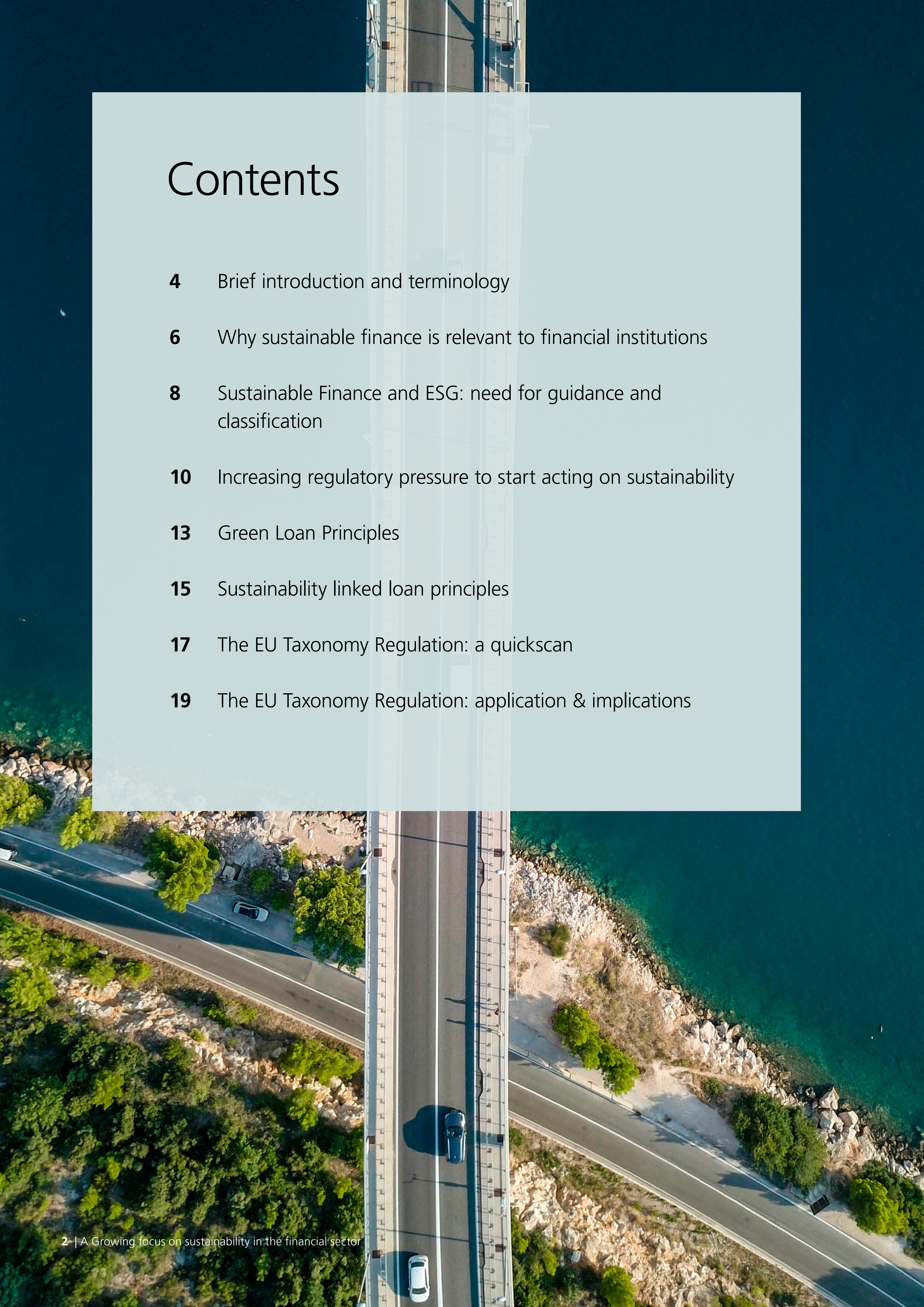
A Growing focus on sustainability in the financial sector

Sustainable Finance

November 2020



Contents

Introduction

The world around us changes at a fast pace. This is mainly due to developments of the climate change and the global population growth. These changes require us to adapt in order to ensure the future of our planet, people and profits. Achieving this goal requires an active approach to sustainability from the whole financial sector.

Sustainable Finance

Financial institutions could position themselves in a variety of ways regarding sustainability. They cannot be silent as diminishing resources and tighter sustainability regulations impact their clients and their ability to pay off debts. Also, the financing of sustainable developments and activities offers a range of new opportunities and clients will expect their bank to reflect on their own approach to sustainability.

A Growing focus on sustainability in the financial sector

With this E-Book we explore the concept of sustainable finance and what it means for the finance industry. After reading this E-Book you are known with:

- Relevant Sustainable Finance terminology;
- Associated sustainability risks and opportunities;
- Regulatory developments and its implications;
- Frameworks which encompass guidance on sustainable finance;
- Tips and considerations on how to anticipate on sustainability trends.

CMS experts

Should you have any questions or do you want to get to know more about Sustainable Finance, do not hesitate to contact us or visit our Sustainable Finance expert Insight page here.

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Brief introduction and terminology

Sustainable Finance; new approach to doing existing things

Sustainable Finance (SF) looks at how investing, lending and financing interact with environmental, social and governance (ESG) issues. It comprises various forms of finance with responsible, ethical or environmentally friendly objectives.

Traditionally, the focus of sustainable finance has been to make profit by investing with a 'green' conscience. However, a transition is taking place to 'smart' green investments that combine profits with solutions to ESG issues. Sustainable finance is therefore not new, but introduces new approaches to doing existing things.

Responsible Investment; an issue of global importance

Responsible Investment (RI) is an investment strategy that integrates ESG factors into investment analyses and decisions. As ESG factors impact on the financial value of an investment, long-term profits in terms of sustainability require a step away from short-term profit as the only definition of value.

RI has quickly moved from being an outlier in the asset management world to an issue of global importance and a priority on political, legal and market agendas. RI creates long-term social, environmental and economic (sustainable) value. It combines financial and non-financial value creation and correctly prices social, environmental and economic risk.

Sustainable finance terminology in brief:

ESG lending: environmental, social and governance lending is conventional lending that incorporates environmental, social and governance criteria underpinned by bespoke reporting and monitoring obligations. Arguably most commercial financial institutions' green products sit within the ESG framework.

Environmental aspects include greenhouse gas emissions; biodiversity loss; pollution and contamination; carbon regulation exposure and renewable energy.

Social aspects include labour practices; community displacement; human rights; health and safety and financial inclusion.

Governance aspects include corruption and bribery; reputation; management effectiveness and diversity.

Ethical lending: ethical lending is conventional lending subject to screening for ethically unsound purposes (e.g. tobacco, alcohol, arms). While a commercial lender funding an ESG loan would typically avoid 'unethical' sectors, there is greater scope within ESG loan market to finance environmental efficiencies or other social or governance-based improvements within those sectors than in traditional ethical lending.

Impact lending: impact lending is the allocation of new capital with a direct and verifiable social or environmental impact. In the current market, impact lending tends to be the domain of microfinance organisations, philanthropic funds and development institutions or otherwise forms the focus of corporate social responsibility policies of larger commercial banks.

Why ESG and Sustainability are relevant for the financial sector

This is a rapidly growing sector, with international policy initiatives giving rise to changing attitudes in the investment and lending community. Clients are increasingly concerned with climate change and resource scarcity and are looking for ways to invest in clean, sustainable initiatives and banks will be at the forefront of the promotion of industry standards in this area and the support of United Nations Sustainable Development Goals (UNSDGs).

Crucially, the negative impact of climate change can be substantially mitigated by banks actively pursuing the opportunities presented by the move to a low carbon economy.

Pressure to start acting now

Financial institutions are experiencing regulatory and commercial pressure to start acting on sustainability, in order to protect themselves from the possible risks of the climate change and to help finance a green agenda. Below we present an overview of some first considerations for financial institutions on how to start acting on sustainability:

- Developing a deep understanding of the principles of sustainable finance;
- Developing and offering sustainability-oriented banking products;
- Engaging with clients on sustainability issues to enable a shift to sustainable technologies;
- Providing trainings to inform business teams and clients about sustainability risks.

> Crucially, the negative impact of climate change can be substantially mitigated by banks actively pursuing the opportunities presented by the move to a low carbon economy.

Moving forward

Financial institutions could position themselves in a variety of ways regarding sustainability. They cannot remain silent, as diminishing resources and tighter sustainability regulations impact their clients and their ability to pay off debts.

Also, the financing of sustainable developments and activities offers a range of new opportunities and clients will expect their bank to reflect on their own approach to sustainability.

Why sustainable finance is relevant to financial institutions

Clients are increasingly concerned with climate change and resource scarcity and are looking for ways to invest in clean, sustainable initiatives. Banks will, and should be at the forefront of the promotion of industry standards in this area.

A risk and a global market opportunity

By virtue of their role as financiers of the real economy, banks are exposed to credit, reputational, legal, operational and market risks that are driven by environmental and social issues that affect their clients and customers.

These risks can stem from the impact that clients have on the environment and society, such as pollution, natural resource depletion and health and safety concerns for communities and employees. They can also stem from the physical impacts that environmental issues such as severe weather events, water stress and fluctuating ecosystem services can have on client performance and success. These non-financial circumstances increasingly present new and diverse opportunities and challenges and directly influence the financial results of companies and financial institutions. On the other side, this offers banks an opportunity to help bridging the finance gap to move to a low carbon economy, e.g. by providing finance capital to clients, including governments, businesses and supranational institutions.

> The financial sector plays a key role in mobilising the capital required to fulfil the global sustainability agenda.

The transition towards green finance and ESG-linked agenda's

With the introduction of green debt financing products, such as green home mortgages and ESG-linked revolving credit facilities, banks and other financial institutions have started a process of transformation towards inclusion of sustainable finance into their business.

We observe that, as the green loans industry evolves, different institutions are taking differing approaches to commerciality of these products. At the same time, also companies are not only increasingly talking about how to address issues of sustainability but are also starting to put it into practice. The importance that investors are increasingly placing on companies with a strong ESG-linked agenda, wakes companies up to the potential of sustainable finance.

Financial institutions can play a role as catalysts of this transition, offering their customers the opportunity to transform their businesses into a sustainable and environmentally friendly business model. They increasingly realise that there is a client interest in sustainable finance products, which will only grow as the regulatory environment changes and the technology advances. Thus, both lenders and clients are searching ways to access and benefit from sustainable finance products.

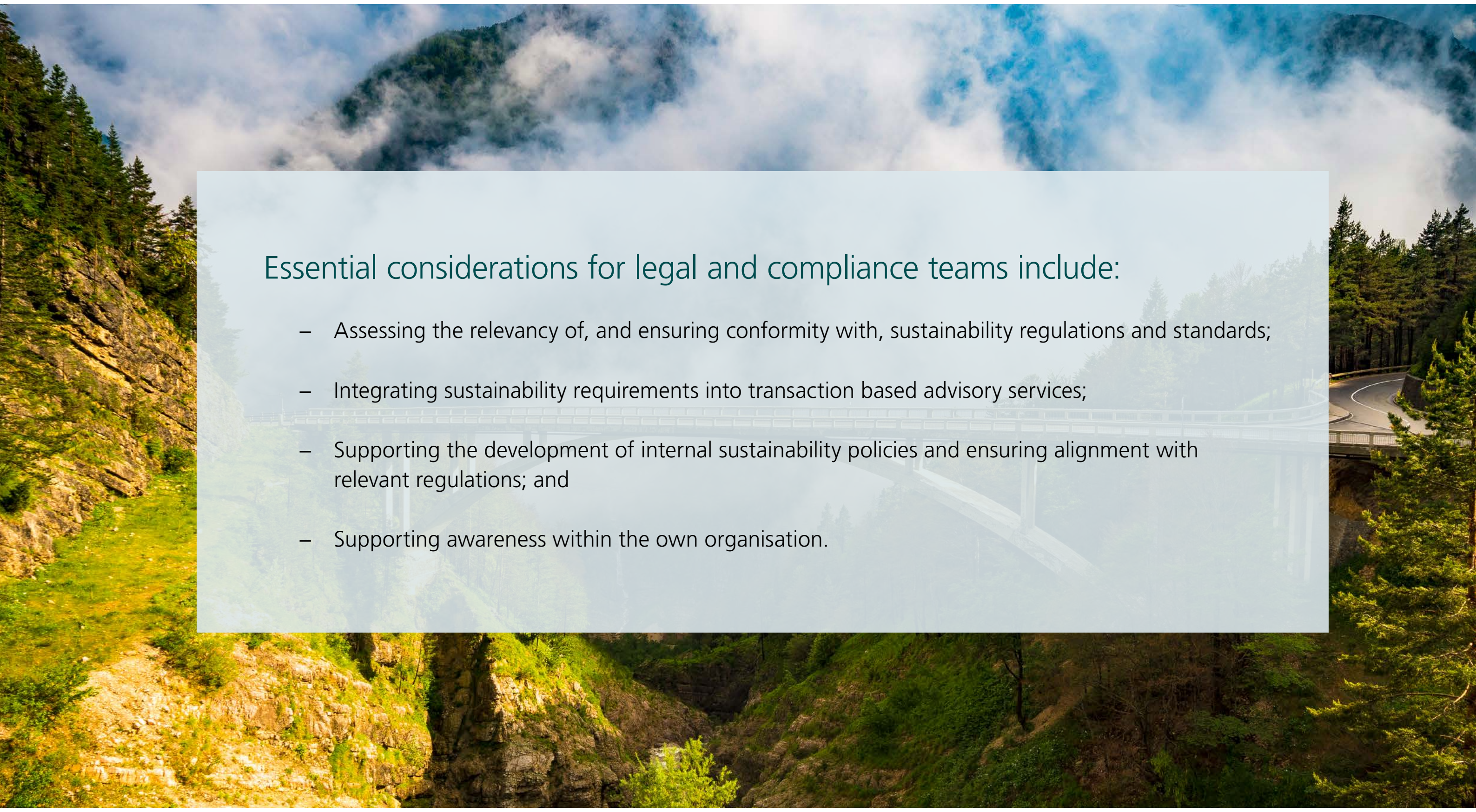
Sustainable policy within the own organisation

There are also various ways that Financial Institutions can drive the development of sustainable finance within their own organisations. This may include setting up a green council with committed employees working on an ESG-agenda, establishing a green framework for a lender's sustainable finance model and creating innovative sustainable finance products that also help encourage top-down support from executives.
A well thought-out ESG agenda is not only about making a company more sustainable but also about making it more efficient and profitable while effectively managing risk.

Addressing legal and compliance aspects of sustainable finance

Proactively addressing legal and compliance aspects of sustainability provides a better safeguard against lender liability and other risks. It also improves the overall resiliency of banks.

Legal and compliance teams have a key role to play, not just to assist with integrating sustainability considerations in regular compliance processes but also to understand and anticipate how the normative landscape is evolving in alignment with fast-moving stakeholder needs and expectations.



Essential considerations for legal and compliance teams include:

- Assessing the relevancy of, and ensuring conformity with, sustainability regulations and standards;
- Integrating sustainability requirements into transaction based advisory services;
- Supporting the development of internal sustainability policies and ensuring alignment with relevant regulations; and
- Supporting awareness within the own organisation.

Sustainable Finance and ESG: need for guidance and classification

Sustainability issues are covered by an extensive array of dedicated conventions, norms and standards that straddle the international, national and local levels. They are increasingly embedded in rules and regulation targeted at companies, investors and financial institutions.

Classification and certification: the assessment of ESG performance

The demand for classification has been driven by institutional investors seeking evermore data on the companies they invest in. This includes not only large pension funds and asset managers – many of which have been assessing the ESG performance of companies held in their equity portfolios for some time now – but increasingly fixed income investors too.

There is a growing acceptance among many investors that there could be varying types of "light green" to "dark green" sustainable investments to consider in the future. For instance, in China banks are already issuing green bonds against brown coal refinancing, which may not appear to be "green", but is deemed sustainable by investors and lenders as it helps to improve social conditions by generating employment.

Ultimately, it may not be possible to have a one-size-fits-all classification and certification system. The market could potentially end up with different league tables and benchmarks linked to specific key performance indicators or other parameters.

However, it is certain that, as more companies, lenders, institutions and governmental bodies worldwide pursue sustainable investments, there will be increasing amounts of data and evidence that can be cross-shared and used to inform and to enhance the harmonisation and certification process.

The broader international regulatory framework

While there is no binding regulatory framework or incentive scheme for sustainable finance, economic activity that could be classed as sustainable would likely be underpinned by reference to one or more of the following documents, which encompass not only financial sustainability but wider social and inclusivity goals: i.e. the EU Green Deal, the Paris Agreement, the United Nations Sustainable Development Goals (UNSDGs), EU Action Plan for Financing Sustainable Growth and the Equator Principles. From a local, Dutch perspective, we can refer to the Dutch Climate Act ('Klimaatakkoord').

Next, we briefly introduce two frameworks which we believe are giving specific 'Sustainable Finance' guidance for financial institutions at the moment: the LMA Green Loan Principles and the European Taxonomy Regulation.

The LMA's Green Loan Principles

One of the best-known frameworks for debt finance is the LMA's "Green Loan Principles" (GLPs). It aims to create a high level framework of market standards and guidelines that provides a consistent methodology for use across the green loan market, but also allows individual loan products to retain their flexibility while preserving the integrity of a developing green loan market.

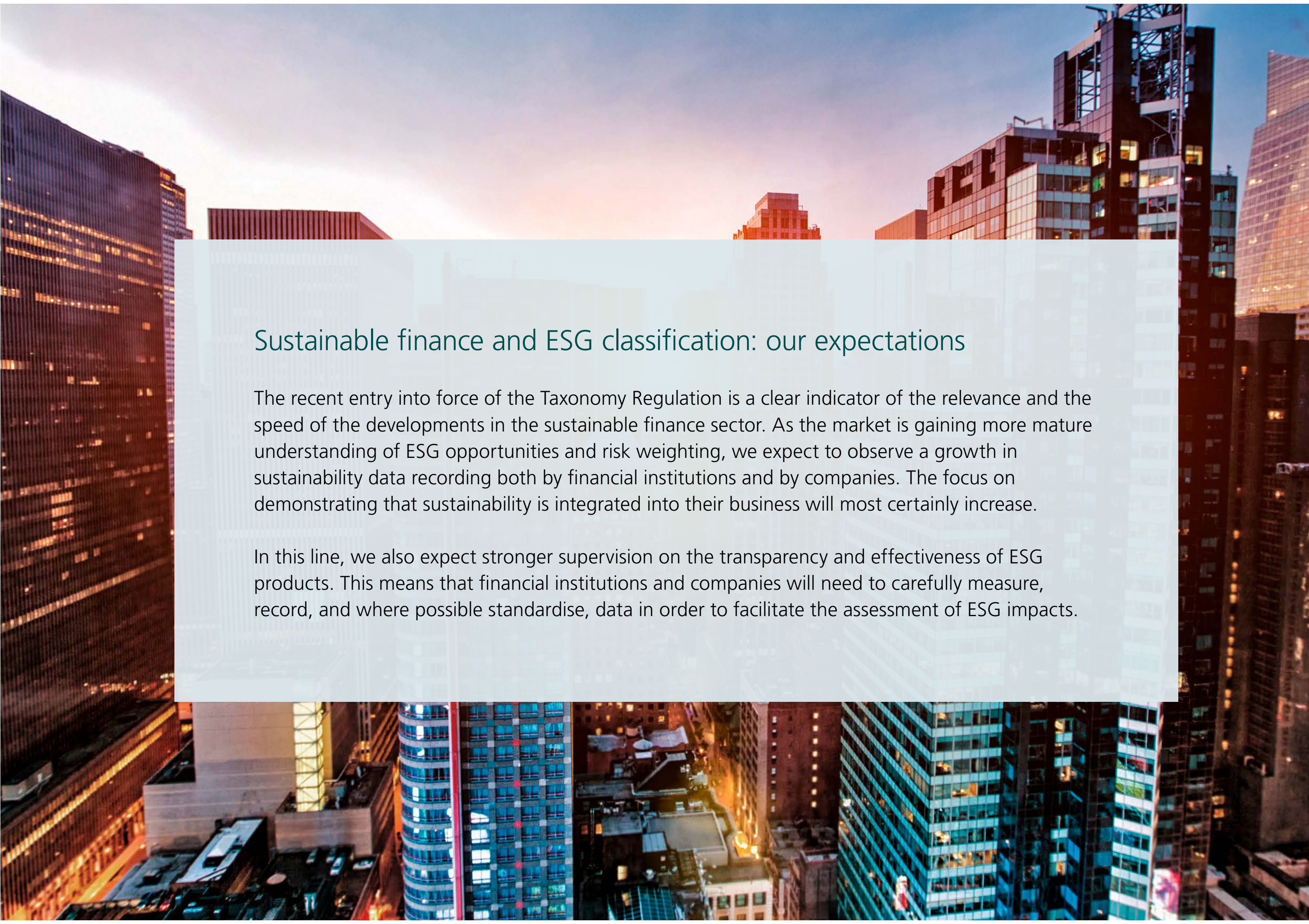
The GLPs are a set of voluntary guidelines issued by the Loan Market Association to aid the development of a market-standard approach to green lending. The GLPs require specific methodologies to be applied to a green loan. A loan instrument qualifies as a green loan if it is made available exclusively to finance or re-finance, in whole or in part, new and/or existing eligible green projects. More details on the GLP's can be found in article 5

The European Taxonomy Regulation

Separately, the European Union has introduced its own taxonomy, a unified classification system, on what can be considered an environmentally sustainable economic activity. The EU believes that this is a first and essential step in the efforts to facilitate the channeling of investments into sustainable activities with a view to complying with EU's commitments under the Paris Climate Change Act.

The Taxonomy is a toolkit for determining which economic activities are environmentally sustainable. The initial plan for the Taxonomy was developed in the context of the European Commission's 2018 action plan on financing sustainable growth. The plan represents the EU's strategy for implementing a financial system that supports its broader climate and sustainable development agenda.

It is expected that financial market participants will be required to complete their first set of disclosures against the Taxonomy, covering activities that substantially contribute to climate change mitigation and/or adaptation, by the 31st of December 2021.



Sustainable finance and ESG classification: our expectations

The recent entry into force of the Taxonomy Regulation is a clear indicator of the relevance and the speed of the developments in the sustainable finance sector. As the market is gaining more mature understanding of ESG opportunities and risk weighting, we expect to observe a growth in sustainability data recording both by financial institutions and by companies. The focus on demonstrating that sustainability is integrated into their business will most certainly increase.

In this line, we also expect stronger supervision on the transparency and effectiveness of ESG products. This means that financial institutions and companies will need to carefully measure, record, and where possible standardise, data in order to facilitate the assessment of ESG impacts.

Increasing regulatory pressure to start acting on sustainability

EU's policy on sustainable finance

The EU's sustainable finance policy supports economic growth while reducing pressure on the environment and taking into account social and governance aspects. As part of the Green Deal the EU Commission presented the European Green Deal Investment Plan. This framework should channel public and private investments that are required for the transition to a climate-neutral, green, competitive and an inclusive economy.

Increased sustainability awareness among financial supervisors in Europe

The financial system is an essential element in facilitating economic growth. Prudential regulation and conduct supervision have the objective of creating and maintaining the stability and integrity of the financial industry.
Financial regulators across Europe are increasingly expounding the view that businesses which have sustainable objectives present a lower business failure and systemic risk. Financial institutions have been under increased regulatory scrutiny by the European financial supervisors. The supervisors want to better understand the financial institutions' vulnerability to climate risk and their readiness for a transition towards a low-carbon economy.

As a result of the economic, political and social trends regulators and financial institutions support the transition to a sustainable economy by including sustainable factors in risk models, product development and governance frameworks.

Sustainable Finance trends in the Netherlands

Promotion of sustainable forms of finance is fundamental to achieving international policy objectives (Paris Agreement and the UN's Sustainable Development Goals). We expect that, in line with the Dutch Climate Act and the Urgenda case, sustainable trends will play a more dominant role in society. In the Urgenda ruling, the Supreme Court ruled that the decision by the Court of Appeal that the Dutch State has to reduce greenhouse gas emissions at a much faster pace than the Paris Agreement's goals and ambitions (reduction of at least 25% compared to 1990 by the end of 2020). Financial institutions play a crucial role in providing financing to more sustainable sectors of the economy. Dutch regulators actively promote this reallocation of credit.

Not only from a credit but also from a risk perspective, financial supervisors have an increasing interest in sustainable trends. Financial institutions are continuously exposed to different risks that could impact financial solidity and the stability of the financial system in general. According to the Dutch Central Bank (DNB) climate risks are identified as a potential threat to the stability of the financial system in general and financial solidity of institutions. In its capacity as a prudential supervisor, DNB should ensure that financial institutions adequately address these potential sustainability risks.

Dutch financial Supervisors and sustainability trends

The Dutch Authority for the Financial Markets (AFM) and DNB are the financial supervisors for the financial industry in the Netherlands. AFM primarily focuses on conduct of business. DNB is the prudential supervisor in the Netherlands. As financial stability is an essential condition for sustainable growth, DNB is committed to a stable financial system including stable prices, solid financial institutions and properly functioning payment transfers. Fostering a forward-looking and sustainable sector is one of the three focus areas for DNB's 2018-2022 Supervisory Strategy.

As the conduct supervisor, AFM will monitor whether companies provide reliable and accessible information on relevant sustainable factors of their activities. Financial institutions must integrate sustainability into their product development, risk management and investing decisions. Financial institutions have to be transparent about how sustainability is incorporated in the governance and business. Customers of financial institutions need to be adequately informed and advised about relevant sustainable factors in support of their financial decisions.

> Minimising risk and maximising financial and other benefits of integrating sustainability in financial institutions requires a blend of expertise and tactics.

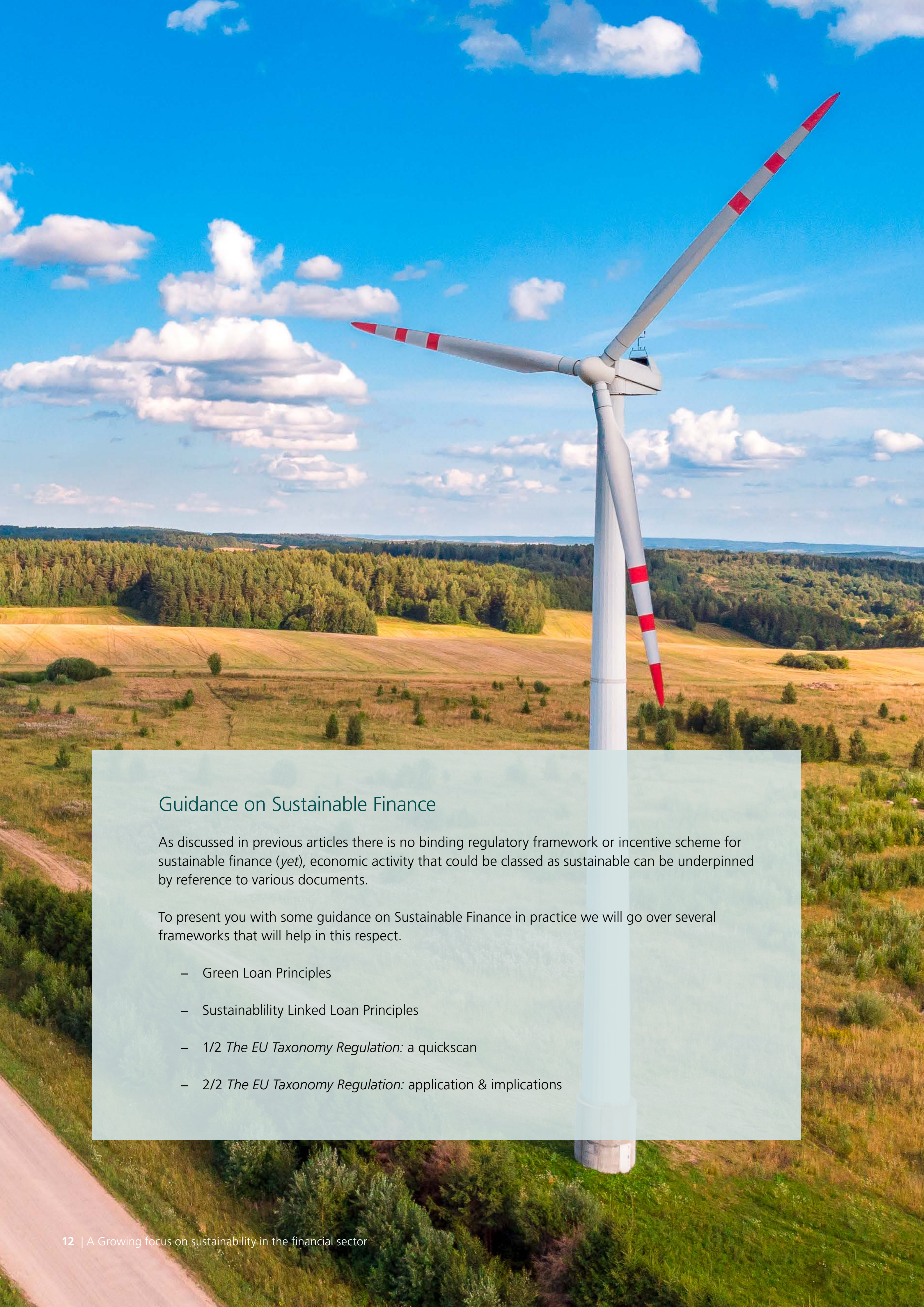
How financial institutions are being impacted by sustainability trends in the Netherlands

Minimising risk and maximising financial and other benefits of integrating sustainability in financial institutions requires a blend of expertise and tactics, such as:

- Developing and offering sustainability-oriented (banking) products and engaging with clients on sustainability issues to enable a shift towards sustainable technologies.

- Creating a more resilient financial institution through an improved understanding of sustainability issues, including environmental and social liabilities by providing targeted trainings to inform business teams and clients about sustainability risk.

- Proactively addressing legal and compliance aspects of sustainability to better safeguard against lender liability and other risks and to improve the overall resiliency of financial institutions by assessing the relevancy of and ensuring conformity with sustainability regulations and standards in cooperation with risk and sustainability teams.



Guidance on Sustainable Finance

As discussed in previous articles there is no binding regulatory framework or incentive scheme for sustainable finance (*yet*), economic activity that could be classed as sustainable can be underpinned by reference to various documents.

To present you with some guidance on Sustainable Finance in practice we will go over several frameworks that will help in this respect.

- Green Loan Principles
- Sustainablility Linked Loan Principles
- 1/2 *The EU Taxonomy Regulation:* a quickscan
- 2/2 *The EU Taxonomy Regulation:* application & implications

Green Loan Principles

The Green Loan Principles (**GLP**) aim to facilitate and support environmentally sustainable economic activity and aid the development of a market-standard approach to green lending.

Green loans (**GLs**) are any type of loan instrument made available exclusively to finance or re-finance, in whole or in part, new and/or existing eligible green projects, including:

Renewable energy – including production, transmission, appliances and products
Renergy efficiency – such as in new and refurbished buildings, energy storage, district heating, smart grids, appliances and products;
Pollution prevention and control – including reduction of air emissions, greenhouse gas control, soil remediation, waste prevention, waste reduction, waste recycling and energy/emission-efficient waste to energy;
Environmentally sustainable management of living natural resources and land use – including environmentally sustainable agriculture, environmentally sustainable animal husbandry; climate smart farm inputs such as biological crop protection or drip-irrigation; environmentally sustainable fishery and aquaculture, environmentally-sustainable forestry, including afforestation and reforestation, and preservation or restoration of natural landscapes;
Terrestrial and aquatic biodiversity conservation - including the protection of coastal, marine and watershed environments;
Clean transportation – such as electric, hybrid, public, rail, non-motorised, multi-modal transportation, infrastructure for clean energy vehicles and reduction of harmful emissions;
Sustainable water and wastewater management – including sustainable infrastructure for clean and/or drinking water, wastewater treatment, sustainable urban drainage systems and river training and other forms of flooding mitigation;
Climate change adaptation – including information support systems, such as climate observation and early warning systems;
Eco-efficient and/or circular economy adapted products, production technologies and processes – such as development and introduction of environmentally sustainable products, with an eco-label or environmental certification, resource-efficient packaging and distribution; and
Green buildings – which meet regional, national or internationally recognised standards or certifications.

All green projects should provide clear environmental benefits, which will be assessed, and where feasible, quantified, measured and reported upon by the borrower.

The below is a summary based on the LMA's guidance document on the Green Loan Principles: https://www.lma.eu.com/application/files/1815/8866/8537/Green_Loan_Principles_V03.pdf

Four key elements which should feature in a GL

1 Use of Proceeds

The fundamental determinant of a GL is the utilisation of the loan proceeds for green projects, which should be appropriately described in the finance documents.
A GL may take the form of one or more tranches of a loan facility. In such cases, the green tranche must be clearly designated, with proceeds of that tranche credited to a separate account or tracked by the borrower in an appropriate manner.

2 Process for Project Evaluation and Selection

The borrower should clearly communicate to its lenders: (i) its environmental sustainability objectives, (ii) the method by which it is established that those objectives are a green project, (iii) the related eligibility criteria, including, if applicable, exclusion criteria or any other process applied to identify and manage potentially material environmental risks associated with the proposed projects, and (iv) any applicable green standards or certifications.

Borrowers are encouraged to position this information within the context of their overarching objectives, strategy, policy and/or processes relating to environmental sustainability.

3 Management of Proceeds

The proceeds of a GL should be credited to a dedicated account or otherwise tracked by the borrower in an appropriate manner, so as to maintain transparency and promote the integrity of the product.

Borrowers are encouraged to establish an internal governance process through which they can track the allocation of funds towards green projects.

4 Reporting

Borrowers should make and keep readily available up to date information on the use of proceeds to be renewed annually until fully drawn, and as necessary thereafter in the event of material developments. This should include a list of the green projects to which the GL proceeds have been allocated and a brief description of the projects and the amounts allocated and their expected impact. Where confidentiality agreements, competitive considerations, or a large number of underlying projects limit the amount of detail that can be made available, the GLP recommend that information is presented in generic terms or on an aggregated project portfolio basis. Information need only be provided to those institutions participating in the GL.

Sustainability linked loan principles

Sustainability linked loans (**SLLs**) aim to facilitate and support environmentally and socially sustainable economic activity and growth. The LMA has published the Sustainability Linked Loan Principles (**SLLP**) to promote the development of sustainability linked loan products by providing a framework for application by lenders and borrowers.

SLLs are any types of loan instruments and/or contingent facilities (such as bonding lines, guarantee lines or letters of credit) which incentivise the borrower's achievement of ambitious, predetermined sustainability performance objectives.

The SLLP can be differentiated from the LMA Green Loan Principles as the SLLP focus on the on-going sustainability profile of a borrower over time rather than the delivery (and maintenance) of a specific green project. It is for the borrower to set sustainability performance targets (**SPTs**) (which are agreed with the lender) by reference to key performance indicators, external ratings and/or equivalent metrics by which the borrower's sustainability profile can be tracked for the purpose of the loan.

The use of proceeds in relation to a SLL is not a determinant in its categorisation and, in most instances, SLLs will be used for general corporate purposes. Instead of determining specific uses of proceeds, SLLs look to improve the borrower's sustainability profile by aligning loan terms to the borrower's performance against the relevant predetermined SPTs.

Category	SPT
Energy efficiency	Improvements in the energy efficiency rating of buildings and/or machinery owned or leased by the borrower
Greenhouse gas emissions	Reductions in greenhouse gas emissions in relation to products manufactured or sold by the borrower or to the production or manufacturing cycle
Renewable energy	Increases in the amount of renewable energy generated or used by the borrower
Water consumption	Water savings made by the borrower
Affordable housing	Increases in the number of affordable housing units developed by the borrower
Sustainable sourcing	Increases in the use of verified sustainable raw materials/supplies
Circular economy	Increases in recycling rates or use of recycled raw materials/supplies
Sustainable farming and food	Improvements in sourcing/producing sustainable products and/or quality products (using appropriate labels or certifications).
Biodiversity	Improvements in conservation and protection of biodiversity
Global ESG assessment	Improvements in the borrower's ESG rating and/or achievement of a recognised ESG certification

The below is a summary based on the LMA's guidance document on the Sustainability Linked Loan Principles:
https://www.lma.eu.com/application/files/5115/8866/8901/Sustainability_Linked_Loan_Principles_V032.pdf

Four key elements which should feature in a SLL

1 Relationship to borrower's overall CSR strategy

The borrower should clearly communicate to its lenders its sustainability objectives, as set out in its CSR strategy, and how these align with its proposed SPTs.

2 Target setting – measuring the sustainability of the borrower

Appropriate SPTs should be negotiated and set between the borrower and lender group for each transaction with the assistance of, if elected, one or more "Sustainability Coordinator(s)" or "Sustainability Structuring Agent(s)".

The SPTs should be ambitious and meaningful to the borrower's business and should be tied to a sustainability improvement in relation to a predetermined performance target benchmark. Market participants recognise that any targets should be based on recent performance levels (often data from the previous 6-12 months). SPTs may be either internal (defined by the borrower in line with their CSR strategy) or external (assessed by independent providers against external rating criteria).

SLLs look to improve the borrower's sustainability profile. They do so by aligning loan terms to the borrower's performance against pre-determined SPT benchmarks. For example, the margin under the relevant loan agreement may be reduced where the borrower satisfies a pre-determined SPT threshold or vice versa. By linking the loan terms to the borrower's sustainability performance, borrowers are incentivised to make improvements to their sustainability profile over the term of the loan.

3 Reporting

Borrowers should, where possible, make and keep readily available up to date information relating to their SPTs, with such information to be provided to those institutions participating in the loan at least once per annum.

As transparency is of particular value in this market, borrowers should be encouraged to publicly report information relating to their SPTs and this information will often be included in a borrower's annual report or its sustainability report. However, this will not always be the case and, where appropriate, a borrower may choose to share this information privately with the lenders rather than making this publicly available.

4 Review

Eternal reviews of the borrower's sustainability performance are likely to be periodically required where the borrower does not have the necessary internal expertise to do so. External reviewers may be auditors, sustainability consultants or rating agencies.

Expansion of usage of Sustainability Linked Loans

The likely advantage for both borrowers and lenders is the positive public profile associated with SLLs. For borrowers the potential to attract sustainability-oriented funding and SPT-linked margin ratchets may be another positive of SLLs.

With the link between economic growth, financial stability and the need for sustainability becoming ever more apparent, we expect SLLs to continue expanding and to become more common.

The EU Taxonomy Regulation: a quickscan

There is a lack of industry-standard measures on how to grade the overall sustainability of a business or an investment. Therefore, a relevant benchmarking tool is offered by the EU Taxonomy: a unified classification system on what can be considered an environmentally sustainable economic activity.

What is the European Taxonomy on Sustainable Finance

The EU Taxonomy is intended as a toolkit for determining which economic activities are environmentally sustainable. It aims to give clarity to stakeholders across all facets of the financial system as to whether, and how, something contributes to the objective of sustainable growth.

It is expected that financial market participants will be required to complete their first set of disclosures against the Taxonomy, covering activities that substantially contribute to climate change mitigation and/or adaptation, by 31 December 2021.

The broader regulatory framework around sustainability

From a political perspective, the Taxonomy sits within a wider framework called the EU Green Deal which seeks to ensure that the EU is carbon neutral by 2050. The EU Taxonomy encompasses the Commission's response to the realisation that the trajectory of the economy was not consistent with EU's obligations as a signatory to the Paris Agreement.

The Commission envisioned the taxonomy in order to give investors in the European market a clear and comparable picture of the investment opportunities that were scientifically proven to be environmentally sustainable, and thus in line with the EU's obligations under the Paris Agreement.

Testing an economic activity on sustainability

The Taxonomy identifies an eligible economic activity in accordance with the so-called NACE industrial classification system. It assesses, by reference to technical performance standards, whether that activity meets certain criteria.

Sustainability requirements

In brief, under the Taxonomy, in order to be 'sustainable' an economic activity must meet the following requirements:

A. It must substantially contribute to at least one of the following six objectives as defined in the Taxonomy Regulation:

1. Climate change mitigation;
2. Climate change adaptation;
3. Sustainable 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.

B. It cannot significantly harm any of the other environmental objectives as defined above (a); and

C. It must comply with minimum safeguards.

Application of the sustainability requirements in practice

Following the EU Taxonomy, an economic activity can substantially contribute to the environmental objective of transitioning to a circular economy in several ways. Some examples are:

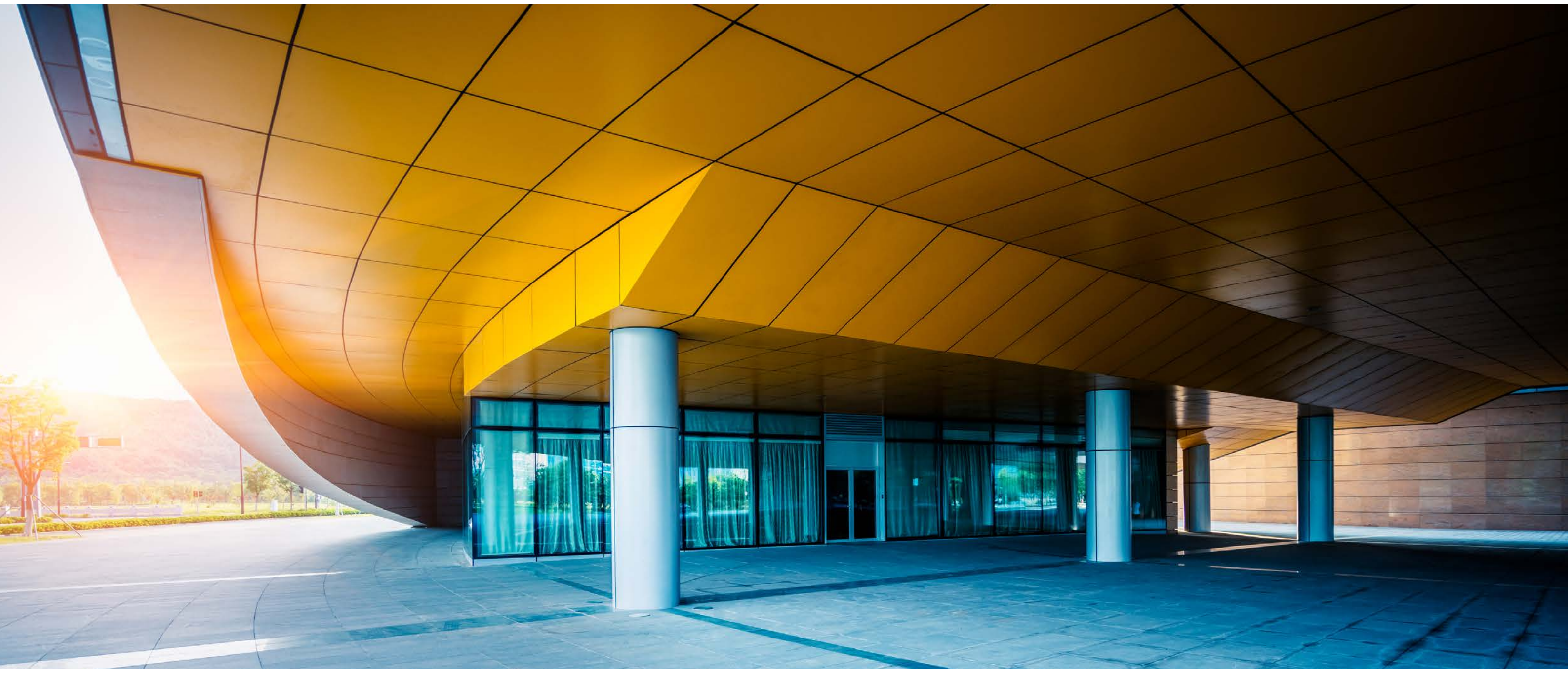
- Increasing the durability, reparability, upgradability and reusability of products. This can be done by reducing the use of resources through the design and choice of materials, facilitating repurposing, disassembly and deconstruction in the buildings and construction sector;
- Transitioning to a circular economy by developing new business models, such as ‘product-as-a-service’ business models and circular value chains, with the aim of keeping products, components and materials at their highest utility and value for as long as possible; or
- Transitioning to a circular economy by reducing food waste in the production, processing, manufacturing or distribution of food.

Who decides if an economic activity is sustainable?

The EU Commission established a Technical Expert Group (TEG) made up of various experts and stakeholders. The role of the TEG is mainly to create the performance standards, the so-called ‘technical screening criteria’, which would render an eligible economic activity truly sustainable and thus aligned with the EU Taxonomy.

The TEG has now created technical screening criteria for the first two requirements: the climate change mitigation and the climate change adaptation.

The Commission will also establish a Platform on Sustainable Finance (PSF). The PSF will develop equivalent technical screening criteria for the remaining four environmental requirements: the sustainable use and protection of water and marine resources; the transition to a circular economy; the pollution prevention and control; and the protection and restoration of biodiversity and ecosystems.



The EU Taxonomy Regulation: application & implications

In our quickscan on the EU Taxonomy Regulation, our first brief article on this subject, we looked at how an economic activity is tested on 'sustainability' under the Taxonomy and on the application of the Taxonomy in practice. In this article we continue looking at the application and implications of the Taxonomy on the loan market and on market practice and on how the Taxonomy is changing financial regulation.

EU Member States, financial market participants and companies and firms will be subject to the requirements of the EU Taxonomy.

Financial Market Participants

The Taxonomy Regulation applies to financial market participants who offer financial products in the European market. Qualifying Financial Market Participants will be required to provide prospectuses, periodic reports, annual reports, marketing documentation and websites on:

- How and to what extent they have used the EU Taxonomy in determining the sustainability of the underlying investments;
- To what environmental objective(s) the investments contribute; and
- The proportion of the underlying investments that are taxonomy-aligned. This proportion must be expressed as a percentage of the fund and must specify both the enabling activities as well as the transition activities.

Companies and firms

The Taxonomy Regulation also applies to companies and firms within the scope of the Non-Financial Reporting Directive (EU Directive 2014/95/EU). The Non-Financial Reporting Directive enhances the transparency of the social and environmental information provided by undertakings in all sectors.

Qualifying entities will be required to include an analysis of the alignment of their activities with the Taxonomy in their annual non-financial corporate reporting. This reporting will have to include a description of how, and to what extent, their activities are associated with Taxonomy-aligned activities by reference to:

- The proportion of turnover aligned with the EU Taxonomy;
- Capex; and
- If relevant, opex aligned with the EU Taxonomy.

The implications of the EU-Taxonomy

In practice, a company that wants a certain economic activity to be 'sustainable', first has to consult the relevant article of the EU Taxonomy Regulation. It will then be able to determine what constitutes (i) a substantial contribution to climate change adaptation and (ii) a possible significant harm to the other relevant EU environmental objectives.

The criteria for establishing what constitutes a 'substantial contribution to climate change adaptation' are context-specific and will be assessed on a case-by-case basis. In addition, the company will undertake an impact assessment to ensure that the measures to be implemented are consistent with local and regional adaptation efforts.

On the basis of the assessments carried-out, the company will then establish the cost of the envisaged 'sustainable' economic activity.

Reporting

In relation to reporting, currently the LMA applies the Green Loan Principles or the Sustainability Linked Loan Principles. Compared to the EU Taxonomy, both sets of LMA principles are relatively light on obligations to provide information and leave this up to the parties to negotiate. This is understandable for a voluntary initiative.

As a result of the disclosure regulations, a significant part of the financial industry will need to start gathering data on green assets within their portfolios. Whilst there will be increased back-office requirements to manage this, these information requirements will also land on the companies and borrowers that own or operate the underlying assets.

Market practice
As financial institutions are required to report on their compliance with the EU Taxonomy, they are likely to want to bring certain assets into line with the Taxonomy requirements. We therefore expect to see the EU Taxonomy and the Disclosure Regulations increasingly impacting on market practice.

Also, banks are increasingly advancing green loans and withdrawing from markets which have an adverse effect on the environment.

The EU-Taxonomy could provide a common market standard method of evidencing that institutions have met these objectives and obviate 'greenwashing' accusations. Indeed, the ultimate goal of the EU Taxonomy is to render it unacceptable to call something 'green' if it does not meet with its conditions.

How the implementation of the EU Taxonomy is changing financial regulation
In terms of regulation, it seems that the EU Taxonomy is gaining traction beyond regulators in Europe. Many central banks are already working on regulation that treats climate change as a systemic risk to financial systems.

This means that corporate governance regulations, rating agencies, banks, insurance companies and asset managers and their advisers will also have to integrate the Taxonomy into their analysis frameworks. In terms of business, prompted by and despite recent events, business leaders across the board continue to make commitments to more sustainable business practices.

While the implementation of the EU Taxonomy helps eliminating the confusion in the market as to exactly what is 'green', there remain a number of other questions to be addressed by governments, regulators and the financial sector relating to the value and treatment of green or sustainable lending in order to achieve the Taxonomy's ultimate goal of facilitating the transition of our present economy into a carbon neutral one.

Tips: how to get ready for managing sustainable economic activities under the EU Taxonomy

- Timely produce and have available the required information and data on your economic activities;
- Timely analyze your economic activities, products and services in terms of the sustainability requirements under the EU Taxonomy;
- Develop a recording system for recording the outcomes of the analysis under (2);
- Align your communications, prospectuses, periodic reports, annual reports, marketing documentation and website in order to include the relevant information on your sustainability policy and sustainable activities; and
- Align your general policies, including internal policies such as sustainable investment, human resources and diversity policies.

How can we help?

At CMS we are committed to support clients implementing sustainable business practice. As such we have developed a new cross-disciplinary ‘Sustainable Finance’ approach which spans regulatory, finance, corporate and energy specialists. Our holistic approach to ESG and climate action draws on specialists from across the firm to advise you.

- Market-leading experience in sectors aligned to green finance such as renewables, ESG funds, green real estate finance and infrastructure deals.
- Advice on the structuring of green finance and impact investment.
- Market-leading financial regulatory advice on EU and national legislation and guidance on sustainability.
- Advice and auditing of ESG risks, reporting and opportunities.

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