6th September

Eurosif position on the Platform on Sustainable Finance's draft report on proposed taxonomy extension options linked to environmental objectives

Introduction

Eurosif welcomes the opportunity to share its views regarding the possible extension of the EU taxonomy for sustainable economic activities, which has been elaborated by the Platform on Sustainable Finance in accordance with its mandate from the European Commission.

Conceptually we are supportive of the exercise being conducted by the Platform regarding the possible extension of the scope of the taxonomy so as to identify: activities that "significantly harm" (SH) environmental sustainability; an intermediate performance level for activities that meet the Do No Significant Harm (DNSH) criteria, while failing to substantially contribute to at least one of the six green objectives of the taxonomy; activities with no significant impact (NSI) on environmental sustainability.

Having said that, we advocate for a **clarification on the policy objectives** that an extended taxonomy would be supposed to pursue.
As a reporting and transparency tool, it might increase the accuracy and the granularity of data available to investors regarding both the harmful activities, and the efforts of the companies to improve their environmental performance. In that case, adequate safeguard measures should be adopted to ensure that an **extended taxonomy is not misused as an expedient to water down the definitions of what is green**. Moreover, we would not consider this workstream as a priority, since investors have already developed and currently use sophisticated methodologies to identify the negative externalities of their investments, at least with regard to climate objectives.
On the other hand, if the taxonomy is intended **as a tool to reorient capital**, we would be cautious on expecting that it can concretely encourage investments in sustainable activities and/or hold back capitals from harmful sectors. Indeed, **capital allocation is mainly driven by pricing mechanisms, rather than transparency and data**. Therefore, at this juncture all policy effort should be concentrated on making green investments more attractive.
On the contrary, extending the taxonomy would add further layers of complexity to the framework without achieving meaningful results in terms of shifting capital allocation.

Further analysis and stakeholder feedback will be critical in order to gain a comprehensive insight into the expected impacts and the effective usability of an extended framework. In particular, the issues that will need further analysis relate to:

(i) the **concrete effect of the taxonomy on encouraging sustainable investments** if not complemented by policy actions aimed at adjusting the pricing mechanism so as to shift capital allocation towards transition;
(ii) the outcomes in terms of **usability**, as the extension of the taxonomy would add a layer of complexity to the framework;
(iii) the **concrete effectiveness of the SH taxonomy** to prevent financial institutions from investing in harmful activities;

(iv) the practical **workability of an intermediate performance space** to capture properly the dynamism of transition and the needs of long-term investors in the real economy, and the **greenwashing risks** connected to this;
(v) the **opportunity to deploy time and resources** to give recognition **to** a further category of **activities that have no impact** on sustainability.

i. Transparency itself is not enough to shift capital allocation

In order to properly assess the concrete impact of an extended taxonomy there must be clarity with regard to the objectives it is pursing.
As a transparency and reporting framework, we believe that an extended taxonomy could, in principle, be **useful to obtain data on the environmental performance** of a wider range of companies and financial products. The current green taxonomy does not provide any information about the activities that do not contribute substantially to environmental objectives. Those activities may have hugely varying effects on sustainability, ranging from damaging, to being immaterial, to retaining a high impact reduction potential while sitting in the middle between negative impact and substantial contribution. More detailed data can inform sound investment decisions aimed at supporting credible transition pathways in the real economy, especially within the sectors that currently exert most impact on the environment.

However, we would be cautious about depending solely on the extension of the taxonomy **as a tool to reorient capital flows**. Capital allocation by investors is largely determined by pricing mechanisms. Thus, data can *inform* a sound investment decision, but not necessarily *make* a sound investment decision, which must satisfy a risk/return calculation. In our view transparency, labels and detailed data can be material to investment decisions when they complement **other policies aimed at intervening on the pricing mechanism so as to penalise negative externalities and/or incentivise positive impacts**. For instance, with explicit and implicit carbon pricing, new emission reduction targets and blended finance mechanisms. Therefore, to boost transition finance and shift market incentives towards sustainability, **the most effective and urgent policy actions should be aimed at making polluting activities more expensive as well as making green economic activities more attractive investment propositions.**

As stated in the consultation report, the sustainable finance initiatives thus far implemented have had a limited impact in terms of boosting transition finance and triggering transition in the real economy. We believe the reason is not so much the conceptual framework of the green taxonomy, nor solely the lack of ESG data, but rather the fact that green and transition activities remain largely uncompetitive if compared with practices that do not integrate sustainability criteria[1]. Additionally, the implementation of the taxonomy is currently limited because the framework is incomplete, and its structure is perceived as complex and burdensome by companies and investors who will be required to report against it.

The taxonomy was conceived as a science-based "gold standard for green finance". An extended taxonomy may require long negotiations, **carry high political costs** and it would invariably lead to a **more complex**

[1] According to estimates by McKinsey, around 50% of the investments in Europe required to meet net-zero by 2050 are not profitable in the current policy environment of the carbon price, taxation and subsidies: https://mck.co/37H4nZZ

framework, placing further pressure on its usability. The efficacy of the taxonomy as a tool to shift capital – without other policy actions – might not be worth all these risks.
Additionally, we would be cautious about burdening **companies and investors with further reporting requirements**, before assessing thoroughly that the information produced are truly decisive for investment decisions.

The conceptual work on the extended taxonomy that is being conducted by the Platform – as a transparency tool – would be much **more effective in the future if it were complementary to other policy actions** specifically designed to **shift market incentive.** With those measures in place, an extended taxonomy could be an asset to accelerate the transition and attain the goals of the EU Green Deal.

These assumptions can be applied to evaluate each proposed extension of the taxonomy. In addition to this, we have included further reflections on the conditions that would be required to make each extension work. Moreover, we identified further risks that should be pondered carefully.

ii. A Significantly Harmful taxonomy is not incisive to prevent harmful investments

From a theoretical standpoint, we agree on the importance to further analyse the negative impacts of certain activities on the environment. A SH taxonomy would be a **useful tool to increase the transparency** on the source and the amount of negative externalities, thus conveying interesting information to investors. In addition to an increased transparency, it would distribute the reporting requirements more equally among companies, while in the current framework a heavier burden falls on the activities that qualify as green or pursue improvements.
In practical terms, we believe **the SH taxonomy is not sufficient to prevent investments in harmful activities** until they remain profitable and still represent a good business case for financial institutions. For instance, fossil fuels are widely recognised as harmful. Still, a recent report found that fossil fuel financing from the world's 60 largest commercial and investment banks was higher in 2020 than it was in 2016, the first year after the Paris Agreement[2].
Furthermore, embarking on a workstream to introduce a SH taxonomy may carry **high political costs** that would hinder the finalization of the framework and perhaps **tarnish its objectivity**. These costs are not likely to be compensated by concrete impacts in terms of discouraging investments in harmful activities.

iii. A taxonomy for an Intermediate Performance Level is an interesting exercise – but could it be operationalized?

In principle, we agree on the importance of enabling a better recognition of the efforts of companies to improve their environmental performance, especially in sectors that are pivotal for environmental action and especially for the activities that do not meet the green threshold, which are the vast majority of companies at this juncture[3].

[2] Rainforest Action Network, Banktrack, Indigenous Environmental Network, Sierra Club, Oil Change International, Reclaimn Finance 2021, *Banking on climate chaos*: https://bit.ly/3Bs5VEe
[3] According to the consultation report, "estimates put the volume of finance that would currently meet Taxonomy alignment 'green' criteria at 1 to 5% of all financial assets".

That said, we see many **hurdles in terms of operationalization**.
First, transition is a highly dynamic process. Any policy action supposed to enhance it should enable investors to react promptly and capture any meaningful technological progress. Accordingly, each update of the thresholds of the taxonomy would require time and political efforts, which would make the whole system **less fit to adapt flexibly** to the needs of the real economy. What potentially compounds this issue is that **if the taxonomy fails to adapt to the mitigation needs of the real economy, it will lose its status as a gold standard** for what is green.
On the other hand, as **long-term investors need stability** in market conditions, an extended framework that frequently tightens its thresholds is not likely to constitute a tool that is relevant or useful for investment decisions.

Furthermore, an over-complicated and intricate system would be more susceptible to misinterpretation and thus **heighten the risk of greenwashing**. Indeed, a IP space would include activities that are close to meeting the technical screening criteria for substantial contribution and activities that are close to significantly harming. More clarity would require sub-categories for IP, thus further convoluting the framework.

The risk of greenwashing is even more evident if we think at the **possible use of the intermediate performance information to define the sustainable investment objective of products that fall under the classification of Article 9** in the Sustainable Finance Disclosure Regulations (SFDR). According to Art. 2(17) of SFDR, a "sustainable investment" is defined as an investment that contributes to an environmental or social objective. Technically, activities in the intermediate performance level do not contribute – at least yet – to any of the environmental objectives of the taxonomy and can be very close to significantly harm. We concede that investment in transition has a huge role to play in mitigating the negative impacts of human activities on the environment, even when they do not meet the criteria for *substantial* contribution. However, allowing "pure green products" to invest in activities that somehow have negative impacts on the environment might easily expose the system to the **risk of greenwashing**.

V. A Non-Significant Impact taxonomy is a resource-demanding activity that would have little role in shifting capital flows towards greening the economy

In principle, a description of the activities that are not included in the taxonomy could be beneficial in terms of increasing the transparency about the environmental performance of companies. Nonetheless, we have reservations about the added value of introducing the **No Significant Impact (NSI) category**. A NSI extension would require new criteria and further negotiations. Those **resources would be deployed to scrutinize activities that are not relevant to environmental action** and do not need sustainability-oriented investments.

Investments in SMEs or other companies supposed to be included in this category can be boosted using other policy measures, more specific to each sector/type of company. On the other hand, a NSI extension would further convolute the taxonomy framework and undermine its usability without producing information material for sustainable investment decisions.