

THE EU TAXONOMY: FOSTERING AN HONEST DEBATE

1st March 2021

The EU Taxonomy: fostering an honest debate

The EU Taxonomy has over the past few months faced criticism from many stakeholders, policymakers and some EU Member States that argue it **will shut out entire industries from capital markets**, severely undermining the competitiveness of the European economy.

This paper seeks to **clarify what the Taxonomy is, which obligations it imposes on whom and also what it is not**. One thing is beyond doubt though: if we want it to be credible and effective in the long run, it needs as much as possible to be science-based. To ensure this, it requires both an honest debate based on facts while not conflating the impact of the Taxonomy with the impact of other policy tools.

Who are we?

Eurosif, the **European Sustainable Investment Forum**, works as a partnership of Europe-based national Sustainable Investment Forums (SIFs). SIF members include institutional investors, asset managers, index providers and ESG research and analysis firms totalling over **€8 trillion of assets under management**, as well as other stakeholders such as NGOs, trade unions, think-tanks and philanthropic foundations.

Our Mission is to **promote sustainable development through financial markets of investments that make a measurable contribution to the sustainable development goals** set by the United Nations, the European Union and other European countries.

What is the EU Taxonomy?

In brief, the EU Taxonomy is a legislative framework setting out a **classification system** seeking to identify economic activities deemed 'environmentally sustainable' based on a scientific assessment, with the technology realistically available today. While the Taxonomy will cover six different environmental objectives, at this stage it covers only the objectives of (1) Climate Mitigation and (2) Climate Adaptation. **Environmentally sustainable economic activities are therefore activities aligned with the objectives of the Paris Agreement, the EU Climate Law and the EU Green Deal** of seeking carbon neutrality by 2050.

What obligations does it impose on whom?

The Taxonomy imposes a **limited number of obligations**. **Large companies** (> 500 employees) will have to report the degree of alignment of their business in terms of turnover and investment (Capital Expenditure) with the Taxonomy as part of the non-financial reporting they already do since 2018. **Financial firms** offering investment products making explicit sustainability or ESG 'claims' will have to disclose the degree of alignment of their portfolio with the Taxonomy. Finally, the **EU and EU Member States** proposing measures to label financial products as sustainable/ESG/green will have to base this on the Taxonomy.

Will the Taxonomy reduce certain companies' or industries' access to capital markets?

There is **no evidence to support this claim**. The EU Taxonomy does not impose any obligation on financial firms to invest or lend partially or exclusively to finance economic activities aligned with the Taxonomy.

As the Taxonomy becomes more usable and investors are more familiar with it, we may over the years see a **gradual differentiation in the cost of capital** between companies depending on their

alignment. However, this is likely to be **caused by other policy instruments that have a more direct impact on revenues and costs** of companies, such as the European Emission Trading System (ETS) or carbon taxes.

Will investors only invest in economic activities aligned with the Taxonomy?

No. First and foremost, institutional investors are required to generate **sufficient investment returns** to meet their liabilities (pensions, insurance coverage) while being **financially stable** by holding sufficient capital (banks, insurers). Therefore, investors and asset managers acting on their behalf will always seek to generate sufficient investment returns first, looking at the underlying profitability of companies and countries they invest in through shares and bonds. The Taxonomy however **only identifies whether an activity is ‘sustainable’ and not whether it is a sound financial investment. And a number of investments required to reach net-zero are currently not profitable (see Annex).**

Furthermore, the full and precise application of the Taxonomy requires data from companies and countries that is currently not always available. As long as these data gaps have not been filled, **investors will only be able to make an imperfect use of the Taxonomy** and will therefore be cautious about giving it a decisive role in investment decisions.

Therefore, it is **unlikely that alignment with the Taxonomy will be a material factor informing investment decisions in the near future.** It is certainly not the case now: available data show that a large majority of sustainable/ESG funds currently marketed are initially not likely to have more than 10% of their portfolio aligning with the Taxonomy (see Annex).

Will the Taxonomy create a ‘green’ financial bubble as demand by investors exceeds the availability of investments aligned with the Taxonomy?

No. This would only be the case if alignment with the Taxonomy becomes a material driver in the way investors allocate their assets or if in the future mandatory investment requirements in Taxonomy-aligned activities would be mandated by law. As explained above, this is very unlikely at this stage.

Will the Taxonomy undermine the transition of certain sectors to meet the goals of the Paris Climate Agreement?

The Taxonomy **only identifies ‘sustainable’ economic activities and nothing more.** For now, it helps identify activities compatible with the objectives of the EU Climate Law and the EU Green Deal of reaching carbon neutrality by 2050. Therefore, it sets targets for sectors, but it certainly does not mandate ‘how’ a particular sector or company needs to transition between now and 2050. **Other policy tools having a more direct link to carbon pricing are likelier to have a greater impact on the transition of certain industries.** Moreover, activities not identified as “sustainable” are not automatically identified as “polluting” or “unsustainable”.

Why is the notion of ‘transition activity’ in the EU Taxonomy so strict?

The concept of ‘transition activity’ in the Taxonomy is a very specific one. It defines economic activities in economic sectors where no technology or economic solutions currently exists that is compatible with the goal of climate neutrality by 2050. These economic activities are not sustainable in themselves but currently the most sustainable in a given sector in the light of currently available technologies. **This concept is not meant to cover all different shades of activities which certain sectors will need to transition from now to net-zero by 2050.**

Is the EU Taxonomy exceeding its boundaries by pre-empting the reviews of EU legislation in other sectors?

No. The Taxonomy identifies ‘sustainable’ activities that are **compatible with climate objectives based on scientific evidence**, to help guide investors towards these types of investments. It is clear that **most economic sectors will need a significant number of years to transition** and meet these objectives at sufficient scale. While many sectoral EU legislation reviewed in the next 2-3 years will seek to establish objectives for the next 10 years, it is probably not advisable to immediately use the objectives laid down in an instrument with a much longer time horizon of 30 years. Moreover, the Taxonomy seeks to define the most sustainable activities. **Activities not meeting this threshold are not automatically considered bad: they just cannot be labelled sustainable. And compliance with applicable legal requirements does not automatically imply an activity is sustainable, else the vast majority of economic activities would be sustainable.**

If the direct impact of the Taxonomy is likely to be limited, why is it important?

The transparency it generates will **gradually inform investors’ and companies investment decisions**, allocating capital to investments aligned with the carbon neutrality objectives. It will also help companies and investors understand their exposure to potential ‘stranded assets’ i.e., activities not compatible with the objective of carbon neutrality by 2050. This is why this transparency tool should be science based to be as objective as possible. **We cannot afford that it sends the wrong long-term investment ‘signals’ to companies and investors.**

Polluting industries will face higher funding costs than ‘sustainable’ ones?

Yes. That is the objective of the EU entire sustainable finance agenda: to re-orient capital to investments contributing to the Climate goals. The aim though is to ensure that this happens gradually and to transform polluting industries into green ones through a just transition process. This is what was meant when the Paris Agreement expressed the need to leverage private finance to complement public finance.

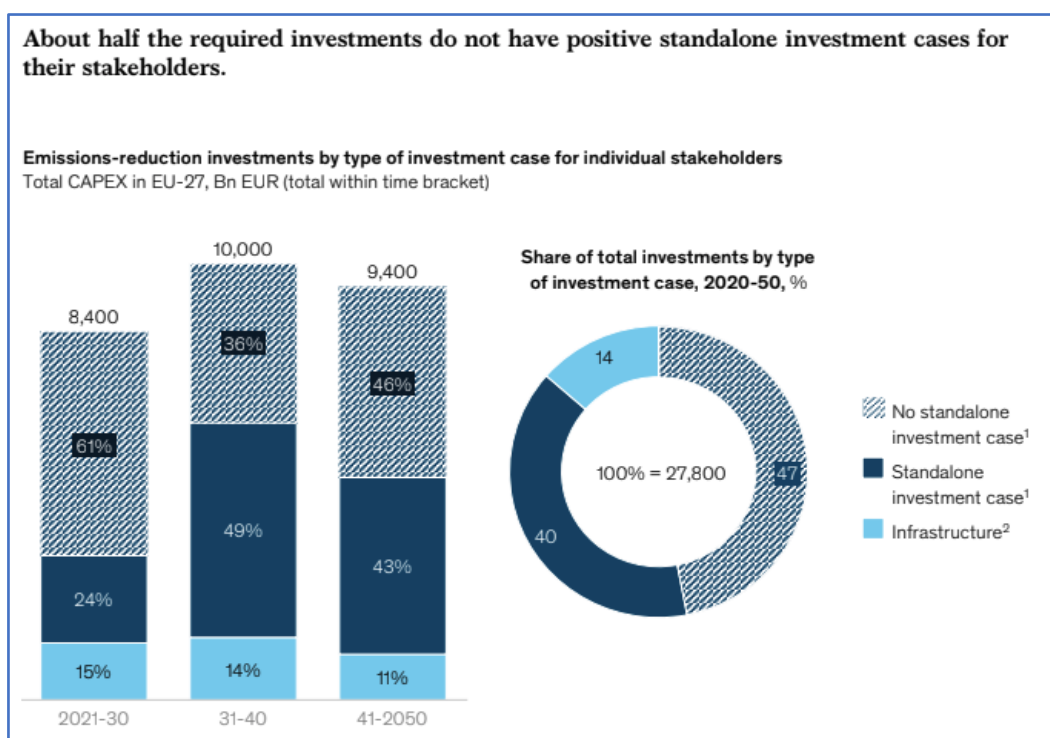
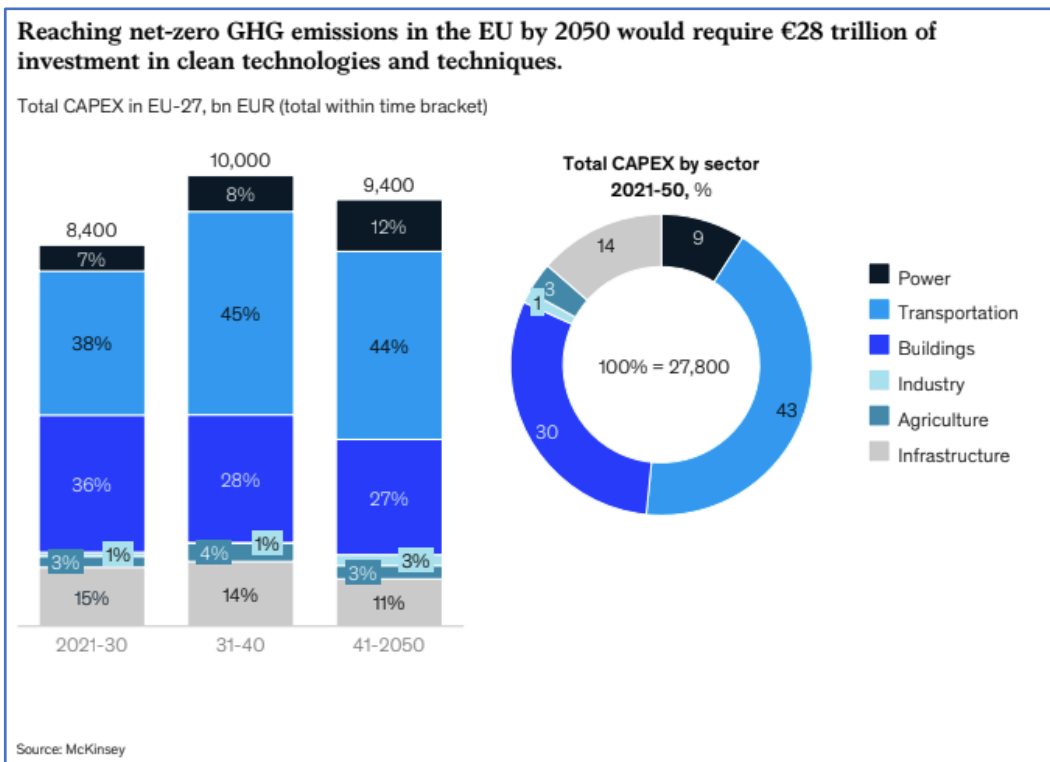
Financial markets and companies are already pricing these differences. While the current ‘carbon price’ in the EU fluctuates between EUR 20-30 ton of CO₂, investors are already basing certain investment decisions on the assumptions of a EUR 50-80 ton of CO₂. Companies are also increasingly using internal carbon pricing that is higher than the current market price, although more can be done.

For any questions or comments you can contact:

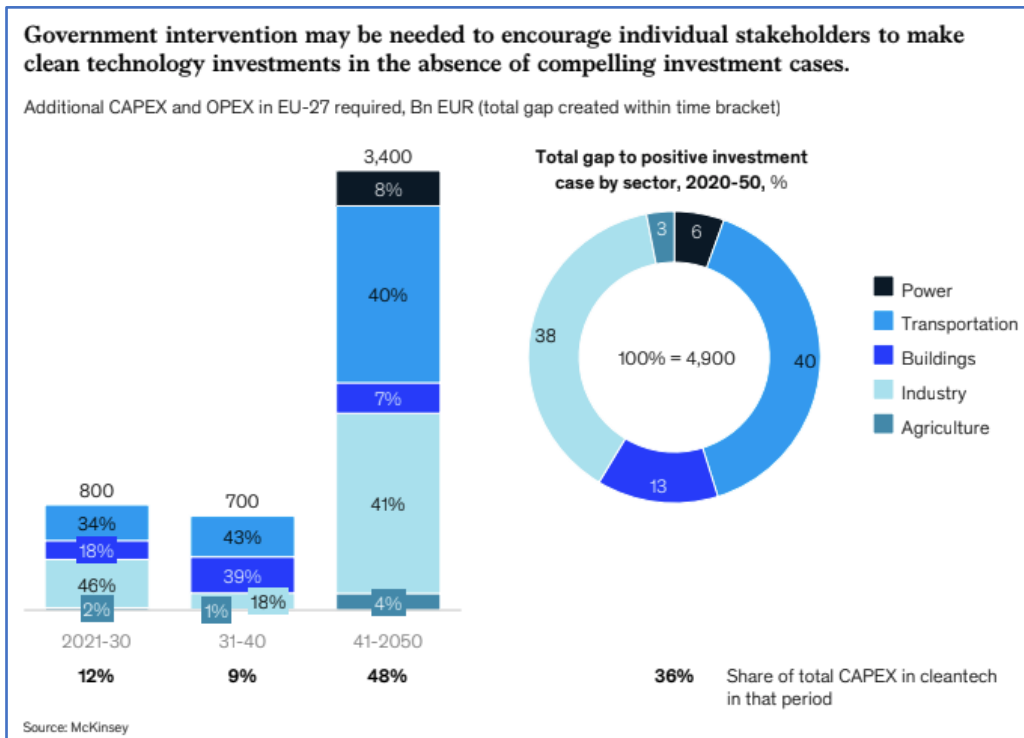
Victor van Hoorn,
Executive Director, Eurosif
E: victor.vanhoorn@eurosif.org

Annex – EU Taxonomy needs support from carbon price to fill investment gap to meet Net-Zero 2050

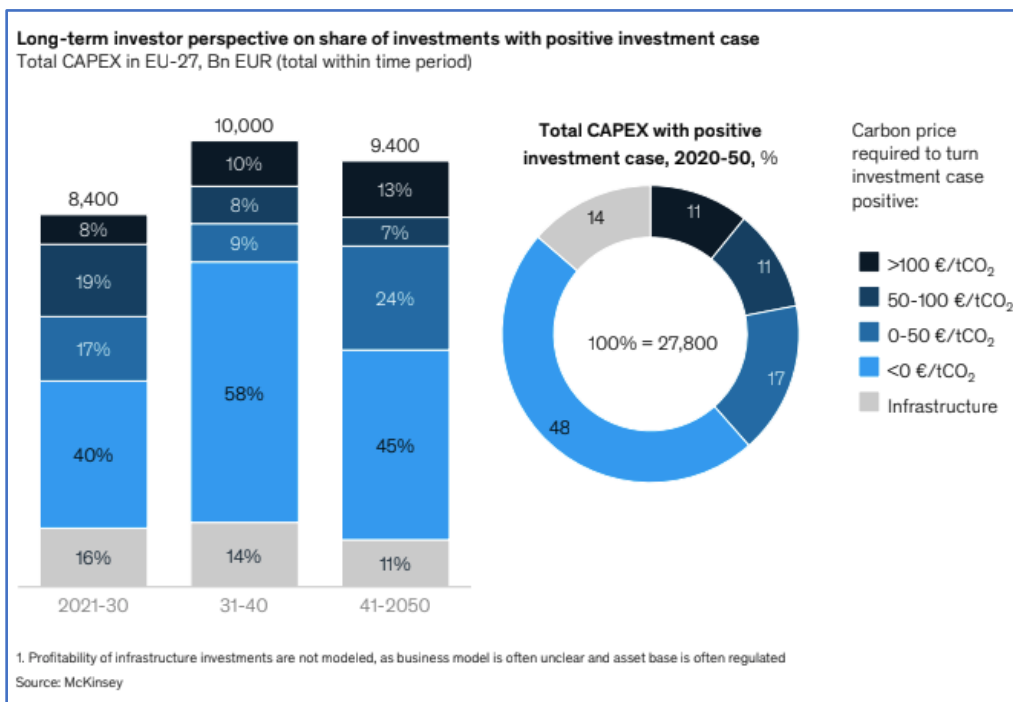
According to McKinsey in its report “How the European Union could achieve net-zero emissions at net-zero cost” (December 2020) [Link], the EU needs EUR 28 trillion in investments in a number of key sectors (power, transportation, buildings, industry, agriculture and infrastructure). One of the keys issues is that **nearly half of these investments currently are not profitable and as a result will be of little or no interest to companies and private investors, unless there is a fundamental shift in the policy environment.**



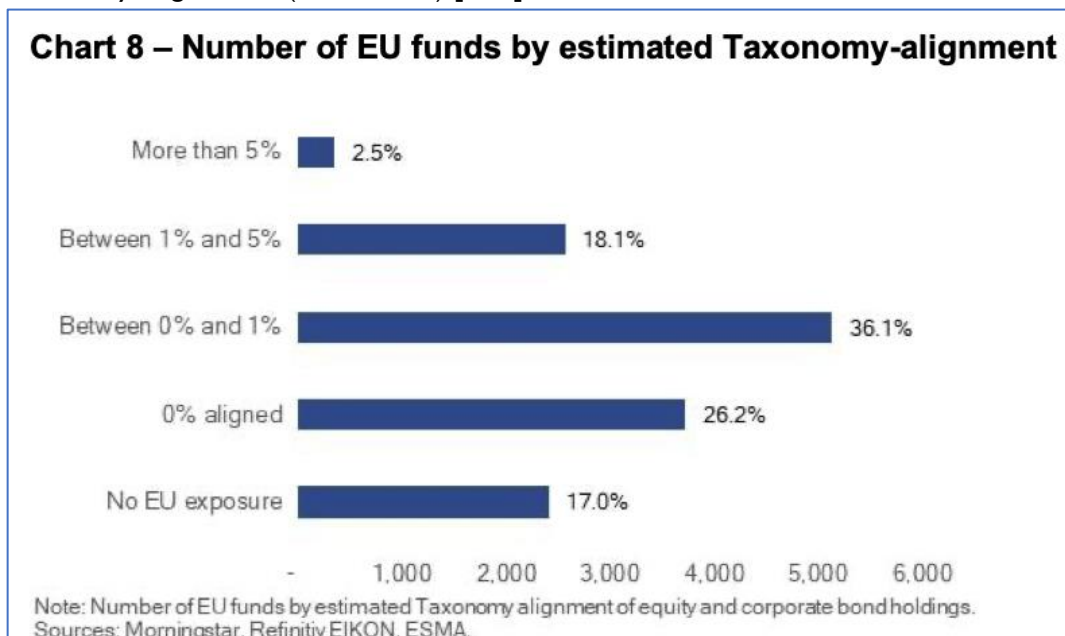
The Taxonomy only help identifying activities that are ‘sustainable’ – not whether it is a sound financial investment. **Therefore, it will not by itself solve this investment gap.** Other policy tools, such as a higher carbon price in the European Emissions Trading System (ETS) will be necessary.



As depicted below, many of these investments that are currently not attractive to investors may become so with a higher carbon price. While the price as over the last year fluctuating between EUR 20 and EUR 30/ton of CO₂, **many investments will require a range between EUR 40 and EUR 100/ton CO₂.**



Unsurprisingly, this does mean that currently the **estimated overall ‘Taxonomy Alignment’ of many investment funds in Europe remains limited**, also due to a limitation in the availability of data required to make this assessment, as ESMA makes clear in its “Final Report Advice on Article 8 of the Taxonomy Regulation” (March 2021) [[Link](#)].



Companies and Investors are however already use internal carbon prices to plan some of their investment decisions, as reported by McKinsey “*The state of internal carbon pricing*” (February 2021) [[Link](#)]. For long-term projects in the energy sector, investors are already integrating in their financing decisions a carbon that is much higher than the current market price of EUR 20 and EUR 30/ton of CO₂.

