Global Counsel

A defining green moment for sustainable finance

Blog post by Practice Lead Elizabeth Beall, 26 June 2019

Something that was easy to miss amidst the headlines of net-zero targets and climate emergency is the release of the EU's Technical Expert Group on Sustainable Finance's taxonomy technical report. The name and the length – more than 400 pages – may be off-putting, but this document holds significant implications for the wider sustainability and climate change agendas, because the way that it has defined what is 'green' is likely to reverberate across sectors for years to come. Three tensions stand out in what has been included, how it will be used and when it will be relevant.

The report provides technical guidance outlining criteria and thresholds for investment, ranging from ICT to agriculture to buildings, including clear metrics for what is green and what's not. It does this on the basis of alignment with six EU priorities, avoidance of significant harm to the environment and respect for a minimum of social norms. To provide an idea of how these areas are weighed up, the exclusion of nuclear energy provides a good example. The threshold of 100 grams of carbon dioxide per kilowatt-hour has been applied for power generation more broadly, which nuclear would fall under, but the significant impacts of nuclear waste – or the second component of the methodological approach of the taxonomy, were enough to have it excluded.

There are various criticisms of this approach including its binary nature and lack of appreciation for national contexts, and on the over-attention given to the 'E' element of ESG with only cursory attention to the S (social) and G (governance) issues. As it stands, the only social issues screened for are compliance with International Labour Organisation core conventions. The tension here is that other factors traditionally included in ESG analysis – like tenure rights or license to operate – are not addressed, which has many in the NGO community concerned that green issues will be put ahead of human rights and local communities' livelihoods.

Manufacturing – one of the largest contributors of greenhouse gas emissions, but also vital to building low-carbon solutions - has been included as 'in' but has been bifurcated by 'greening of' and 'greening by'. 'Greening of' relates to reducing the emissions and environmental impact of a particular sector – like aluminium production – and is largely tied to existing EU ETS benchmarks. 'Greening by' is the manufacture of products to support a transition to a low-carbon economy, e.g. aluminium for lighter, more efficient vehicles. The two tracks carry different criteria and aim to differentiate what the specific investment will be used for. While the rigour and level of detail in capturing 'shades of green' is welcome, there is a risk of it either not being well understood by those that need to apply it or that the dual track is used to game the way that an activity is reported against or screened (e.g. 'greening by' does not have to meet a GHG reduction threshold 'because the benefits these lead to are considered to outweigh their emissions').

Given the contentious debate on this file in the European Parliament earlier this year, the release of this technical report has stirred up some of the ongoing areas of contention around how it will be used. Unsurprisingly, the taxonomy largely relies on existing EU legislation, policies and goals, and where there aren't any, points to voluntary initiatives including certifications and standards as the benchmark. For now, the guidance is just that, and the Expert Group has resisted claims that the 'voluntary' guidance will be used as the *de facto* list of what's sustainable and what's not – in a more general sense. However, in the current political discussions within the European Parliament, the proposed legislation does indicate that the taxonomy would eventually be embedded in EU law as a means of sustainability classification. With this being passed onto the new parliament – one looking much more green – it is likely that there could be an increasing push to make the guidance mandatory. The wider implication is that these definitions will become a part of the environmental acquis of the European Commission, thus wrapping them into EU law and applying them beyond finance. This makes it even more important to get the definitions right, but also more difficult to find agreement given the range of sectors and interests implicated. The Finnish presidency will need to find a compromise among countries firmly locked in their positions on voluntary vs. mandatory criteria.

The most significant area of contention is not on the guidance itself but on the fact that it might already be outdated. This idea is advanced by opposing sides of the debate. Greens are advocating for a ratcheting up of thresholds in line with the Paris Agreement, while many businesses are arguing that the guidance is already behind where innovation has reached. This boils down to a tension around what the objective of the taxonomy is – whether it should be a means for steering 'greater' funding into historically less funded but needed areas (stated objective), or whether it's about defining more broadly what's 'good' to invest in, even if many of the benchmarks or thresholds would not signify any advancement from the status quo.

How these tensions are resolved will largely play out over the autumn and under the auspices of the Platform on Sustainable Finance. What is clear is that far more than the finance community needs to be getting up to speed - and quickly - on how their sector is being addressed (or not). And how they can engage in the next round of debate on what is defined, how it will be used, and when it will apply.