PRI Principles for Responsible Investment

INVESTOR BRIEFING

EU TAXONOMY

Political agreement has been reached on the EU Taxonomy. The regulation sets out the legal framework for the Taxonomy, including new disclosure obligations for investors and companies.

AT A GLANCE

Financial products offered in the European Union will be required to make reference to the Taxonomy. The requirement differs depending on the type of fund, as defined in the regulation on sustainability-related disclosures in the financial sector[1].

Products that have sustainable investment as their objective or which promote environmental characteristics, either alone or in combination with other objectives, will have to disclose:

- how and to what extent they have used the taxonomy in determining the sustainability of the underlying investments;
- To what environmental objective(s) the investments contribute; and
- The proportion of underlying investments that are taxonomy eligible.

All other products can disclose against the taxonomy or carry a disclaimer that "*the investment(s) underlying this financial product do not take into account the EU criteria for environmentally sustainable investments*".

Large companies who are required to provide a Non-Financial Statement under the Non-Financial Disclosure Directive will also be required to disclose how and to what extent its activities are aligned with the Taxonomy. Specifically for non-financial companies, the following information is required:

- The proportion of turnover/revenues aligned with the taxonomy; and
- CAPEX and if relevant, OPEX aligned with taxonomy.

Timing: The first set of technical screening criteria, covering activities that substantially contribute to climate change mitigation and adaptation, will be issued by December 2020 and enter into force by December 2021. Further technical screening criteria for activities that substantially contribute to other environmental objectives (circular economy, pollution, water and ecosystems) will be issued by December 2021 and enter into force in December 2022.

[1] See section "Who is affected".

WHAT IS THE TAXONOMY?

The EU Taxonomy is a tool to understand whether an economic activity is environmentally sustainable.

The Taxonomy sets performance thresholds (referred to as "technical screening criteria") for economic activities which:

- make a substantive contribution to environmental objectives – starting with climate change mitigation or climate change adaptation; and
- avoid significant harm to other EU environmental objectives (pollution, waste & circular economy, water, biodiversity).

They must also meet minimum social safeguards, defined in reference to the UN Guiding Principles on Human Rights and the OECD guidelines.

BACKGROUND AND DEVELOPMENT

The Taxonomy is the first action in the European Commission's Action Plan on Financing Sustainable Growth. The Taxonomy has a political and a technical stream.

Political: A proposed regulation was issued in May 2018 and political agreement was reached in December 2019. This sets out the legal framework for the Taxonomy, including its use by Member States, investors and issuers, its ongoing governance and minimum social safeguards. The regulation empowers the European Commission to develop delegated acts (subsidiary regulations) which will include the individual technical screening criteria.

Technical: The Technical Expert Group on Sustainable Finance – an independent advisory body made up of members from finance, industry, the public sector and civil society – was established in June 2018 to help develop the technical details of the Taxonomy, as well as make recommendations on corporate climate disclosure, low carbon benchmarks and an EU Green Bond Standard. On 18 June 2019, the TEG released a technical report on the Taxonomy which sets out a working model for a future Taxonomy, including a first set of 67 technical screening criteria. The TEG will issue final recommendations to the Commission in early 2020.

WHO IS AFFECTED?

The Taxonomy regulation refers to the definitions embedded in the regulation on sustainability-related disclosures in the financial sector, which defines financial products as;

- a portfolio managed in accordance with Article 4(1) of Directive 2014/65/EU (MiFID II);
- an alternative investment fund (AIF);
- an Insurance-based Investment Product;
- a pension product;
- a pension scheme;
- a UCITS fund; or
- a Pan-European Personal Pension Product.

The Disclosure regulation defines three categories of fund;

- Financial products which have sustainable investment as their objective (“Article 9” products);
- Financial products which promote, amongst other characteristics, environmental or social characteristics of the investment, which will include ESG integration and stewardship-focussed strategies (“Article 8” products); and
- All other financial products (Article 7 products).

Article 9 funds and Article 8 funds which include environmental objectives are required to disclose against the taxonomy. All other Article 8 funds and Article 7 funds can elect to disclose against the taxonomy, or provide a standard disclaimer.

OTHER ISSUES

The political agreement reached in December 2019 included a range of issues beyond the original Commission proposal. These are summarised below:

Alignment with existing regulations: The text makes clear links between the taxonomy regulation and the regulation on sustainability-related disclosures in the financial sector (PRI briefing here). This will help to establish a clear and coherent package of disclosure obligations.

Brown and social taxonomy: the Regulation creates a review clause which would allow the Commission to investigate extension of the Taxonomy to activities which cause significant harm to environmental objectives (“brown taxonomy”) and to social objectives.

Transition activities: the Taxonomy will signal whether an economic activity that substantially contributes to climate change mitigation is a zero-carbon, transition or enabling activity. The effectiveness of these categories will be reviewed periodically.

Governance: the regulation establishes a Platform on Sustainable Finance to manage the ongoing development of the technical screening criteria. In addition, the regulation establishes a Member State Expert Group which will contribute in an advisory role. The technical screening criteria will implemented via delegated acts.

Minimum social safeguards: these were strengthened to make reference to the OECD guidelines and UN Conventions on human rights.

Controversial sectors:
- Solid fossil fuels are excluded;
- Nuclear and gas are neither explicitly included or excluded in the Level 1 text. Decisions will be made at the technical level.

PRI VIEW

The PRI believes the Taxonomy is a generational shift for responsible investment. Read our blog here. PRI welcomes the ambitious and timely political agreement. The deal:

- Gives certainty to investors. The first Taxonomy rules will be published in December 2020 and the first disclosures will be required by December 2021. Investors can start to prepare now.

- Provides a practical tool to support the market to understand which activities are consistent with environmental objectives, for use in investment and stewardship activities.
- Addresses the number one concern – data. The deal will require large European companies to disclose their taxonomy-aligned revenues and if relevant, CAPEX and OPEX.
- Ensures that the Taxonomy will remain rigorous and science-based by establishing an independent Platform on Sustainable Finance. Decisions on controversial sectors like gas and nuclear will be taken at a technical level.

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The PRI engages in public policy to remove barriers to a more sustainable financial system, consistent with the PRI's mission and strategy.