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EUROPEAN TAXONOMY REGULATION: IMPLICATIONS FOR FINANCIAL ANALYSIS

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Introduction

In response to the evolving sustainable finance landscape, the European Federation of Financial Analysts Societies (EFFAS) is pleased to launch the periodic ESG Position Notes. This initiative addresses the need for clear guidance amidst the rapid changes and challenges in regulations aimed at fostering a sustainable economy. Key regulations like European Taxonomy for sustainable activities, Sustainable Finance Disclosure Regulation (SFDR), and Corporate Sustainability Reporting Directive (CSRD) are central to Europe's sustainability agenda, yet their complexity poses challenges for professionals in the financial sector. The EFFAS ESG Position Notes aim to clarify these regulations, making them more accessible for financial analysts and practitioners. By drawing out the strengths and weaknesses of regulatory details and linking them to practical financial analysis and decision-making, these notes support the industry's evolution towards sustainable investment.

European Taxonomy Regulation: Implications for Financial Analysis

The European Taxonomy Regulation[1], a key element of the European Union's Action Plan on Sustainable Finance, is a classification system establishing a list of environmentally sustainable economic activities. It aims to provide clarity and transparency on sustainability to investors, companies, issuers, and project promoters, facilitating the growth of sustainable investments. This regulation plays a pivotal role in directing investments towards more sustainable technologies and businesses. It is a science-based tool that categorizes environmentally sustainable economic activities, playing a crucial role in guiding investments towards a sustainable economy. The European Taxonomy Regulation, hereafter Taxonomy, entered into force in July 2020 and became applicable on 1st January 2022.

What is the Taxonomy?

The Taxonomy outlines six environmental objectives:

- Climate change mitigation.
- Climate change adaptation.
- The sustainable use and protection of water and marine resources.
- The transition to a circular economy.
- Pollution prevention and control.
- Protection and restoration of biodiversity and ecosystems.

Under this regulation, the European Commission has issued its initial set of technical screening criteria, which specify by each industry involved[2] the economic activities that contribute to climate change mitigation and adaptation. To be classified as "environmentally sustainable," an economic activity must meet four criteria:

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[1] Regulation (EU) 2020/852

[2] The taxonomy covers a wide range of sectors, focusing on those with significant potential to contribute to environmental goals, such as: Energy production, transmission and storage; Transport, development and operation of low-carbon public transport systems and production of electric vehicles; Construction and renovation of buildings; Manufacturing processes that contribute to the circular economy, such as recycling and upcycling of materials; Waste management activities, waste prevention, recycling and conversion of waste into energy; Water and waste management activities and use of water resources; Agriculture and forestry practices that contribute to climate change mitigation and adaptation, protection of water and soil resources and conservation of biodiversity.

1. It must adhere to the Technical Screening Criteria (TSC) to determine its eligibility.
2. It must make a Substantial Contribution (SC) to one or more environmental objectives.
3. It must not significantly harm any other environmental objective. (Do Not Significant Harm or DNSH principle)
4. It must comply with Minimum Social Safeguards (MSS).

Impact on Corporate Value

For financial analysts, the Taxonomy is a useful tool for evaluating the sustainability profile of companies. It helps in assessing how company's activities align with the EU's environmental objectives. Companies that align well with the Taxonomy are likely to attract more investments, enjoying a potential "green premium", while those that do not may face a "brown discount". Notably, the Taxonomy covers more than 100 activities across various sectors, influencing a wide range of industries. The Taxonomy provides companies with an opportunity to assess their performance and advancement in achieving environmental objectives transparently and in a standardized manner. Strong alignment with the Taxonomy has the potential to enhance a company's reputation, to facilitate the shift to a more sustainable economy, and to increase the access to finance. EFFAS is therefore firmly of the opinion that the taxonomy facilitates the assessment of companies by investors and the access of companies to finance.

The generation and access to Taxonomy data is crucial for financial market participants, including the banking, financial services, and insurance sectors, to make informed investment decisions and evaluate potential financing opportunities. Initiatives such as the European Single Access Point (ESAP), European Sustainability Reporting Standards (ESRS), and the application of eXtensible Business Reporting Language (XBRL) significantly enhance the financial ecosystem. These efforts improve the efficiency, transparency, and effectiveness of sustainability assessments by ensuring that Taxonomy and other ESG-related data is accessible in machine-readable formats.

EFFAS recognizes the crucial role of integrating Taxonomy information into financial analysis. This is vital for evaluating companies concerning risk profiles, governance, and business dynamics, ultimately fostering long-term market stability, transparency, and a reduction in volatility and political-social instability risks.

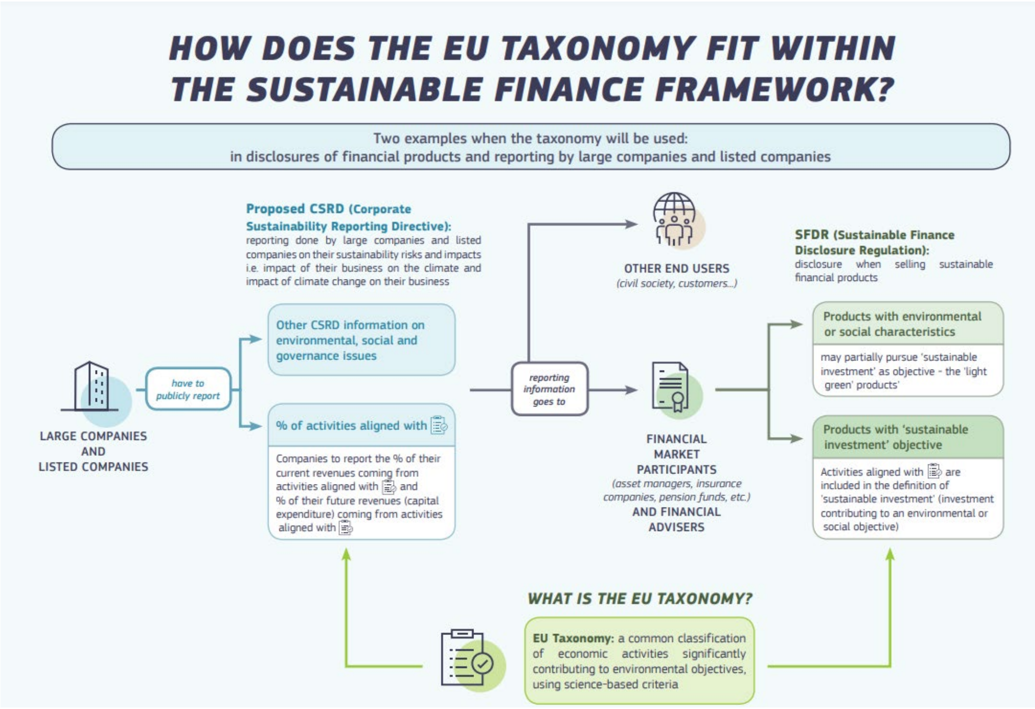
Interconnection with SFDR and CSRD Regulations

The SFDR and CSRD are closely linked to the Taxonomy.

SFDR requires transparency of sustainable information at the entity and financial product level, and it was specifically designed to contribute to this objective by offering investors disclosure templates. On one hand, it provides information about sustainability risks that may affect investments (outside-in), and on the other hand, it sheds light on the negative impacts these investments may have on the environment and society (inside-out). These concepts underpin the "double materiality" that gives rise to two fundamental requirements that regulators must consider in ensuring their effectiveness: the integration of sustainability risks and the assessment of "principal adverse impacts" on sustainability (PAI).

CSRD extends sustainability reporting requirements, ensuring that companies disclose information about their environmental and social impacts. Through the ESRS, the aim is to harmonize sustainability reporting across the European Union, thus enabling companies to report on their sustainability performance in a consistent, comparable, and reliable manner. Such standardization is essential to verify companies' adherence to the Taxonomy.

Together, these regulations create a comprehensive framework for sustainable finance, where the Taxonomy serves as a reference point.



Source: European Commission, Factsheet on EU Taxonomy for sustainable activities

Strengths in Taxonomy Implementation:

- **Enhances Transparency and Consistency**: By setting clear standards, it mitigates the risk of greenwashing, ensuring that claims of sustainability are both credible and verifiable.
- **Defines Sustainable Investments**: It precisely identifies which activities are considered "green" and should be prioritized for funding, facilitating the transition to a low-carbon economy.
- **Promotes a Sustainable Economic Shift**: Supports the transition towards a more sustainable economy by guiding investment into activities that have a positive environmental impact.
- **Empowers Informed Investment Decisions**: Provides investors with the essential information to make detailed and informed choices, not just within Europe, but globally, enhancing the flow of capital towards sustainable initiatives.

Critical Issues in Taxonomy Implementation:

- **Implementation Complexity**: Highlights the multifaceted challenges companies face in adopting the Taxonomy, emphasizing that its complexity stems not only from technical aspects, but also from its political dimension.
- **Unrestricted Data Exchange**: Stresses the importance of seamless and unrestricted sharing of Taxonomy data, crucial for transparency and effective implementation across sectors.
- **Taxonomy Scope Expansion**: The alignment of the EU economy with the Taxonomy is at this stage limited, around 5%. Calls for extending the application of the Taxonomy to new sectors, which is currently being examined by the European Sustainability Platform expert group. This includes the development of an 'Extended Taxonomy' for sectors currently outside the scope and a 'Social Taxonomy' for a more comprehensive sustainability framework covering all E, S and G dimensions as well as all economic sectors.

- **Global Taxonomy Alignment**: Underscores the effort to achieve convergence and interoperability with other international sustainable finance Taxonomies, facilitating a unified global approach to sustainability criteria.

Conclusion

Part of EFFAS' discussion is the European Taxonomy Regulation, which serves as a cornerstone in the EU's framework for sustainable finance. The Taxonomy provides a clear and detailed classification system, delineating what constitutes "green" and should be prioritized for financing or transformation. Its purpose, scope, and key objectives are to direct investments towards sustainable projects and activities, thereby facilitating the European Green Deal's agenda and contributing to the achievement of the EU's climate targets. By defining what is sustainable, the Taxonomy lays the groundwork for a unified approach to financing the transition towards a low-carbon, sustainable economy.

EFFAS is committed to providing clarity and actionable insights through the EFFAS ESG Position Notes, aiding financial professionals in aligning their practices with the EU's environmental and social objectives. The integration of the Taxonomy, alongside SFDR and CSRD regulations, represents a significant step forward in promoting sustainable investment practices. However, to fully realize the potential of these initiatives, EFFAS recommends the following improvement actions:

- **Broaden Geographic and Sectoral Coverage**: To ensure the applicability and relevance of the taxonomy globally, it is essential to broaden its scope.
- **Simplify Reporting for SMEs**: Making the reporting process more accessible for SMEs will encourage broader compliance and participation in sustainable finance.
- **Ensure Continuous Adaptation**: Regular updates to the Taxonomy, informed by technological and market developments, will keep it relevant and effective.
- **Foster Enhanced Stakeholder Engagement**: Active dialogue with a diverse range of stakeholders will refine the Taxonomy's criteria, ensuring it reflects the current sustainability landscape.

EFFAS remains dedicated to supporting financial analysts and the wider financial community in navigating the evolving landscape of sustainable finance, promoting transparency, consistency, and informed decision-making in pursuit of a more sustainable and inclusive economy.

For more detailed information visit the official pages on the European Commission's website:
https://finance.ec.europa.eu/sustainable-finance/tools-and-standards/eu-Taxonomy-sustainable-activities_en

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The ***EFFAS CESG*** was established in October 2007 to facilitate the integration of ESG factors into investment processes. Composed of investment professionals from leading European and global sell-side and buy-side firms, including fund managers, financial analysts, and equity specialists, the CESG has been mandated by EFFAS to achieve several objectives. These include establishing and coordinating EFFAS's position on ESG reporting, measurement, and valuation; consolidating ESG expertise among European investment professionals; extending ESG efforts beyond individual EFFAS member companies; engaging in policy, academic and industry initiatives on ESG issues; organizing European-level conferences on ESG issues; and representing EFFAS in international conferences and projects related to ESG issues. CESG serves as a reference and networking Centre for ESG integration efforts of investment professionals across Europe.
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