

The EU Taxonomy Regulation: learning from practice

Assunção Cristas, Vanda Cascão and Miguel Ventura of VdA analyse the EU's Taxonomy Regulation, assessing its potentially transformative ESG requirements as well as its shortcomings



As ESG standards are becoming increasingly relevant in the market, the EU Taxonomy Regulation, approved by the European Parliament and the Council on 18th June 2020 (EU Taxonomy), is a crucial piece of legislation and an extremely useful tool. The EU Taxonomy aims to promote transparency and sustainability through a unified classification system of economic activities as 'green' or 'sustainable'.

With the purpose of achieving a more sustainable future for the EU and its citizens, in 2018 the European Commission adopted 'Action Plan: Financing Sustainable Growth' which paved the way for the approval of the EU Taxonomy. The EU Taxonomy is part of a broader sustainable finance agenda, that combines a shift towards more sustainable economic activities with the need for a shared understanding of what 'sustainable' means.

The EU Taxonomy was envisioned as:

- A transparency tool that introduces reporting obligations through a common language;
- A comparability tool between investments; and
- A guide to investors and stakeholders.

It is intended to help achieve the EU's climate and environmental objectives, namely:

- Mitigation of climate change;
- Adaptation to climate change;
- Sustainable use and protection of water and marine resources;
- Transition to a circular economy;
- Pollution prevention and control; and
- Protection and restoration of biodiversity and ecosystems.

This 'green' classification system appears at first to relate exclusively to the 'E' pillar of ESG – not only due to its jargon but also to the extent it addressed environmental and climate objectives. But the EU Taxonomy promotes a more comprehensive and holistic approach to sustainable finance through the inclusion of social and governance dimensions. In fact, to be taxonomy aligned, the activity must:

- Substantially contribute to at least one of the six environmental objectives;
- Do no significant harm to any of the others, which in both cases is analysed through the lens of the technical evaluation criteria; and
- Comply with the Minimum Safeguards.

This latter exercise involves a significant amount of information and legislation, as it covers a wide range of legal topics demanding highly specialised and varied legal expertise. Moreover, the Minimum Safeguards demand a value chain analysis which represents an indirect effect on companies that due to their size are unlikely covered by the EU Taxonomy obligations.

The EU Taxonomy is far from being completed. The delegated regulation concerning the two climate objectives (the Climate Delegated Act) and the delegated regulation that specifies the content and presentation on the information to be disclosed have been approved, but the delegated regulation concerning the other four environmental objectives is currently on a four-week feedback period launched by the Commission on April 5, 2023

Besides that, the Taxonomy is foreseen as a dynamic tool, that is expected to include more activities. The amendment regulation relating to the energy sector is just one example. The most dynamic sectors will battle to include activities and engage in the preparation of the corresponding technical evaluation criteria, in line with the Taxonomy provision of periodical assessments and updates.

The EU Taxonomy: Driving change

The EU Taxonomy is part of a broader regulatory framework that includes the EU Sustainable Finance Disclosure Regulation (SFDR), which requires financial market participants and financial advisers to disclose how sustainability risks are integrated into their investment decision-making process. It also includes the EU

Corporate Sustainability Reporting Directive (CSRD), which ensures companies report on a broad range of sustainability and climate-related issues. Thus, despite companies not being required under the EU Taxonomy to align their activities with environmental targets, such disclosure may be required under the existing or coming legislation.

But will businesses and companies that ignore the changes set by the EU Taxonomy survive or be outclassed?

Companies feel a growing pressure for attracting investors and increasingly position themselves in line with the social and environmental cornerstones. Such reconfiguration of investors' priorities follows current market trends whereby consumers ever more tend to opt for products and services aligned with the social and environmental dimensions. Many companies that are not even obliged under the Taxonomy due to dimension or activity, tend increasingly to follow its rules and, in the first case, opt to do a voluntary alignment exercise.

By providing clear guidelines for what constitutes a sustainable investment, the EU Taxonomy is undeniably driving change in the behaviour of businesses and investors, and playing a larger role than it might seem at first.

Time will show the practical implementation of the EU Taxonomy by market players and whether the transition has been achieved successfully – as well as the outcome of pioneers and of those resisting change.

Taxonomy: a practical approach

The year 2022 was crucial for the EU Taxonomy Regulation as theory came into practice. For the first time, companies assessed the alignment of their economic activities with the criteria set out under the Delegated Acts. As expected, the practical application of a complex instrument raised many interesting questions and challenges.

The frontline of the challenge is data collection. Large companies had to adapt, as systems already in place for sustainability reporting became insufficient for the new needs. This is no small issue, it is burdensome and has many organisational impacts.

Not only do companies need more data, they also need to look at it from new

perspectives. Sustainability data collection and reporting has always needed both technical and legal perspectives, but the taxonomy disclosures brought with them more emphasis on legal work to comply with extensive regulations.

Even with the help of very welcome guidelines and FAQs, the extent and nature of these regulations inevitably leave space for different interpretations. It has become very clear as more companies prepared their disclosures that different perspectives existed on the same topics.

Minimum Safeguards are a good example of this interpretative challenge. The legal provision contains the interesting option of referring the interpretation to relevant international environmental, social, and human rights standards. Namely, the OECD Guidelines for Multinational Enterprises on Responsible Business Conduct (OECD Guidelines for MNE), the UN Guiding Principles on Business and Human Rights (UNGPs), the eight fundamental conventions identified in the Declaration of the International Labour Organisation on Fundamental Principles and Rights at Work as well as the International Bill of Human Rights. Complementing this referral is the 'Final Report on Minimum Safeguards', published on October 2022 by the Platform on Sustainable Finance, a group established by the European Commission to provide advice on the development of sustainable finance policies. This document does not bind the Commission or the companies making the exercise and leaves the Minimum Safeguards' complex analysis to be carried out in different ways with different results.

A simple look at the way Minimum Safeguards are considered in the annex II of the DDA (Regulation (EU) 2021/2178) reveals such difficulties. A 'yes' or 'no' compliance with Minimum Safeguards is requested for each economic activity, when it is the most common understanding that this type of compliance should be assessed at the level of the undertaking and not at the activity level.

From structural issues to simple presentation choices, we can find inconsistencies in determining the proportion of turnover for the contribution of an aligned activity. Some used the proportion of the total turnover of the company and others considered just the

turnover proportion of the activity that contributes to each environmental objective.

The way companies deal with the concept of ‘activity’ is another interesting challenge that came out as the legal framework moved from theory into practice. The very first article of the Taxonomy Regulation announces what seems to be a dichotomous ‘yes’ or ‘no’ for the qualification of an economic activity as environmentally sustainable, but this qualification becomes a proportion when all the activities of an investment are considered together.

It is true that an activity can only be eligible or not, but the same is not true for the alignment. The same activity often takes place inside the same company in different sites and in very different contexts. For example, for an international company that is doing ‘acquisition and ownership of buildings’: the same activity relates to different buildings, different cities, and different countries. It is an interesting exercise to find the appropriate level of analysis and determining the proportion on alignment within an activity that is entirely eligible.

A relevant conclusion from the first practical approach is how relevant qualitative and contextual information is. In any case, a taxonomy exercise always implies taking options, but in a context where companies are still using different interpretations, the explanations and contextual information become even more critical for a clear understanding. This means that, for instance, the use of technological tools to respond to the alignment exercise is to be assessed carefully. At least in the beginning, a relevant number of choices and explanations are foreseen to be unavoidable.

Taxonomy and financial undertakings

Under the EU Taxonomy Regulation, financial entities are required to disclose the proportion of their investment portfolio that aligns with the Taxonomy’s criteria for sustainability. They are also required to disclose how they have assessed the

sustainability of their investments and how they plan to transition to a low-carbon economy. The key performance indicators for financial undertakings shall only be disclosed from 1 January 2024, but the ongoing work with non-financial undertakings for 2023 disclosures helps anticipate some of the challenges that will be found when preparing these taxonomy reports.

The base approach is very different from non-financial companies. It has different problems, as it is an exercise constructed on the taxonomy report of others, almost a ‘second degree’ taxonomy exercise. This explains the extra year before reporting and is the reason for the exclusion of undertakings not obliged to publish non-financial information from the numerator of the Green Asset Ratio (GAR) (in the case of credit institutions).

The data collecting challenge that non-financial companies are now facing also exists for financial companies as they are incorporating taxonomy reporting of other entities. Besides all the problems with estimates, there are situations where underlying entities should have reported their taxonomy alignment, but the report does not exist or is not available. There is also the inverse situation of investees or clients reporting their taxonomy alignment while not obliged to do so, and this information should be excluded from the numerator of the GAR.

It is also worth considering the responsibility of financial institutions when incorporating the taxonomy information to create their own. There will be inconsistencies between data coming from the same entity and different options and interpretations among different entities. How much verification is expected from the financial institutions and what responsibilities come with that needs further clarity.

Because the taxonomy analysis for financial institutions is so structurally different from other companies, the many learnings from 2023 will not solve the challenges that will be faced when reporting in 2024.

Upcoming challenges

Although there has been progress as regards the practical implementation of the EU Taxonomy, the complexity of the framework still presents several challenges.

Firstly, as a new legislative instrument, this classification still lacks an interpretative clarity, which inevitably comes only with its continuous implementation.

Additionally, there are still data gaps in some areas, and these need to be addressed to ensure the completeness and effectiveness of the regulation. The Taxonomy regulation must rely on accurate and reliable data for the classification of the environmental performance of economic activities.

Moreover, under the current EU Taxonomy framework, the only approved Delegated Acts refer to the climate change mitigation and adaptation objectives. Therefore, the absence of Delegated Acts for the remaining climate goals may create uncertainty for investors, companies, and regulators.

Furthermore, the EU Taxonomy regulations need to ensure that companies do not engage in greenwashing (making false or misleading claims about the environmental benefits of their products or services). For such purposes, rigorous verification and enforcement mechanisms must be implemented.

Considering that a substantial amount of data and analysis are required to determine whether an economic activity is sustainable, small and medium-sized businesses (SMEs) may not have the resources to comply and could find this particularly difficult. As such, a careful balance needs to be struck to avoid additional burdens for SMEs and increase of compliance costs.

Overall, the EU Taxonomy faces several challenges, but if it is implemented effectively, it has the potential to promote sustainable investments and contribute to the transition to a low-carbon, sustainable economy. In fact, the signs are already visible.