European taxonomy and sustainable investment

BY PAOLO L. CARBONE

This paper aims to examine the European taxonomy, its origins, its objectives, and the current reference regulatory framework, highlighting the economic purposes and the advantages that investors and companies qualified as 'sustainable' activities could derive, but also the limits and critical issues related to the real application scope of Regulation (EU) 2020/852.

1_ EUROPEAN TAXONOMY: ORIGINS THE 2030 AGENDA

To fully understand what the European Taxonomy is and what it is for, and thus try to give a definition of it, it is necessary to take a step back and understand the context in which it is set.

In September 2015, the governments of the 193 member countries of the UN signed the so-called '2030 Agenda for Sustainable Development': an action agenda for people, planet, and prosperity.

The 'Agenda' is divided into 17 Common Macro-Goals for Sustainable Development cd. SDG's (Sustainable Development Goals), in turn defined and specified through a total of 169 targets or goals and more than 240 indicators.

The official launch of the Sustainable Development Goals coincided with the beginning of 2016, guiding the world on the road ahead over the next 15 years: countries, in fact, have committed to achieving them by 2030.

They are deemed 'Common Goals' insofar as they affect all countries and all individuals who populate our Planet Earth.

No one should be left out or left behind in the complex journey that must make our world a sustainable place.

The 17 Goals, depicted by colourful icons with immediate visual impact, cover the following themes:

1_ the fight against poverty;
2_ the elimination of hunger;
3_ health and welfare of peoples;
4_ quality education for all;
5_ gender equality;
6_ clean water and sanitation;
7_ clean and affordable energy;
8_ decent work and economic growth;
9_ enterprise innovation and infrastructure;
10_ reduction of inequality;
11_ sustainable cities and communities;
12_ responsible consumption and production;
13_ fighting climate change;
14_ life underwater;
15_ life on Earth;
16_ peace, justice and sound institutions;
17_ partnership for the goals.

Through the 17 SDGs, an integrated vision of sustainable development is proposed, based on four pillars: economy, society, Environment, Institutions, and three fundamental principles: integration, universality, and participation.

In 2019, the reconnaissance one three years after the effective launch of the SDGs showed clear but not entirely comforting signs. It was found that despite the magnitude of the actions put in place, the change of direction toward sustainable development had moved at an insufficient speed and intensity, making it clear that the next decade would be decisive in marking the present and future of humanity and the planet.

In fact, examining the evolutionary trends of each SDG up to 2017 (excluding, however, the target 6 in the absence of data for a composite indicator), even retrieving historical data prior to the launch of the 2030 Agenda, from 2010, it was evident that only nine out of 17 Goals (3, 4, 5, 7, 8, 11, 12, 13 and 14) marked a clear improvement, while for five of them (1, 2, 9, 10 and 16) the situation remained almost unchanged and even worsened in two cases (15 and 17).

However, taking only the sample from 2016, the year of the Agenda's inception, to 2017, the 2019 analysis reported improvements for about two-thirds of the cases (the ten Goals 1, 2, 3, 4, 5, 8, 10, 11, 14 and 16); stability is noted for the remaining Goals (7, 9, 12, 13 and 17), except for Goal 15 (life on Earth), which still manifests a worsening [(1)].

Also, during 2019, in an international context that confirmed the strong difficulties of a multilateral approach to the many global problems: at the time there were growing trade tensions between the United States, China and the European Union itself; the difficult Brexit negotiations were being pursued; and the divergent positions among European countries on how to deal with migration, environmental and economic issues were significant. In this difficult context, the European Union has, however, operated in the global landscape by being a carrier of values in line with those of the 2030 Agenda, both at the UN and within other international organizations, consistent with the provisions of the Lisbon Treaty.

The following year in 2020 the global pandemic of Covid-19 ravages Europe and the world for more than two years.

If in 2021 the implementation of Agenda 2030 was reporting serious delays around the world in 2022, an additional element of global crisis was added: Russia's aggression against Ukraine [(2)]. This revived geopolitical logics that one hoped were a legacy of the past, not only that.

The devastating human losses, the millions of refugees add up to very serious consequences for the balance of the world economy extended to the entire international community.

Seven years after the signing of the SDGs, significant steps backward must be recorded. Now in the middle of the ford, when time is beginning to run faster, it becomes increasingly necessary to multiply efforts to achieve a sustainable future while keeping the UN 2030 Agenda as a compass.

The topic of sustainability, however, cannot be properly declined without addressing that of financial sustainability through sustainable finance. The 2030

1 In this regard see the Istat SDG's Report 2019, statistical information for the 2030 Agenda in Italy, online can be read at https://www.istat.it/it/files/2019/04/SDGs_2019.pdf; as well as the Asvis (Italian Alliance for Sustainable Development) Report Italy and the Sustainable Development Goals, which can be read online https://asvis.it/raiuto-asvis-2019/.
Asvis has published two further reports for the year 2021 and 2022. The latter can be read online: https://asvis.it/public/asvis2/files/Rappello_ASviS/Rappello_ASviS_2022/RappelloASviS2022.pdf.

2 2022, for sustainability policies in Italy began with good news. The fundamental principles of the Constitution were updated for the first time, with the reform of Article 9, introducing the protection of the environment, biodiversity, and ecosystems, also in the interests of future generations. Similarly, in the part of the Charter that concerns economic relations, the art. 41 the concept of environmental protection in carrying out public and private activities.

Agenda, in fact comes with the Addis Ababa Action Plan (3), which laid the foundation for financing sustainable development and aligning financial flows and policies with economic, social, and environmental priorities.

2_THE EUROPEAN UNION AND CLIMATE NEUTRALITY. THE FRAMEWORK OF REGULATORY INTERVENTIONS

In the broad context of the 2030 Agenda and the Addis Ababa Action Plan, on the eve of the pandemic, the European Union, by deciding to be *carbon neutral* to 2050 [(4)], is imparting significant acceleration and initiating a path of policies and actions to financially support a sustainable, green, and digital transition of the economic system.

The Commission has made clear the rationale behind this commitment: the economy must reduce its environmental impact. This commitment, however, is not economically indifferent especially in the short term.

Estimates for a transition to a *low-carbon* economy, according to Brussels amount to about 180 billion euros per year [(5)]. Unattainable only with public funds, according to the Commission itself. That is why the contribution of private capital proves necessary. Brussels has put its spotlight on the world of finance as a pivotal tool for directing capital flows to responsible business within the framework of sustainable economic development.

The realization that the European public financial system alone is incapable of achieving its goals, as well as centring the framework on private finance as well to create economies of scale and increase overall impacts, determines regulatory interventions that are synergistic with each other: tiles all of a single mosaic.

The starting act for these initiatives is the *Action plan on sustainable finance* (launched on March 8, 2018), which, incorporating most of the recommendations of the *High-Level Expert Group on Sustainable Finance*, outlines the measures the

3 The financial framework, all-encompassing and consistent with the achievement of the SDGs, was outlined with the Addis Ababa Action Plan. Signed in July 2015 by the 193 member countries of the United Nations during the Third International Conference on Financing for Development, the Plan identifies over one hundred concrete measures to address the economic, social, and environmental challenges that the world must face.

4 All 27 Member States have committed to making the EU the first climate-neutral continent by 2050. To achieve this goal, they have committed to reducing emissions by at least 55% by 2030 compared to 1990 levels.

5 Other sources including ‘Il Sole 24 Ore’ in an article from March 2022 refer to annual investment values of 520 billion. The article can be read online: https://www.ilso le24ore.com/art/la-tassonomia-europea-opportunita-la-finanza-sostenibile-AEluiIMB?refresh_ce=1.

European Commission intended to take to guide the transition of the financial sector and the capital market toward a model of development that is sustainable, inclusive, and in line with international commitments. These measures identify the three pillars of European Sustainable Finance:

1_ the creation of a science-based classification system of sustainable activities (the so-called 'Taxonomy');
2_ the introduction of a mandatory disclosure regime for companies, both financial and non-financial, regarding their impact on the environment and society, as well as the sustainability-related operational and financial risks they face;
3_ the provision of a set of tools (such as benchmark indices, standards, norms and labels) aimed at supporting companies, financial market participants and intermediaries, in aligning their investment strategies with the Union's environmental objectives.

To make the Action Plan efficient, as well as to support the Commission in implementing it, the Commission establishes the *Technical Expert Group on Sustainable Finance* (TEG): a group of 35 sustainable finance experts and more than 100 consultants.

The TEG is asked for an unambiguous definition of which economic activities-and which investments-can be defined as sustainable, since every ESG rating agency, every financial manager, every investment fund has a definition, applies its own criteria and methodology when selecting a portfolio of sustainable issuers. Here, then, is the need for an unambiguous and unified vision at the European level, a real selection of standards that ensure the sustainability of investments.

The TEG, therefore, conducts in-depth studies on four themes:
1_ the SRI taxonomy, i.e., a single classification system of economic activities that can be defined as 'sustainable' (with priority given to climate change mitigation and adaptation issues);
2_ improved guidelines on the reporting of climate change-related activities by banks, insurance companies and other large enterprises;
3_ common criteria for the construction of low-carbon and positive-carbon impact benchmarks, i.e., reliable benchmarks to reduce the risk of greenwashing and increase market transparency;
4_ the Green Bond Standard, a European quality certification for green bonds.

The TEG began its work in July 2018. Although the work was scheduled to be completed in June 2019, the final report on the 'EU taxonomy', the Taxonomy: Final report of the Technical Expert Group on Sustainable Finance, was published on March 9, 2020. It is a 67-page document of executive summary and 600 technical annexes to rank the main economic sectors (70), based on their ability to mitigate or adapt to climate change: Those that are already environmentally sustainable (low carbon), those that pollute, but cannot be done without, and are asked to do what they can to improve (transition to a zero-emissions economy, but cannot be called zero carbon at present), and those that are beneficial to the other two categories (enabling), thus enabling other activities to have low-carbon performance or significant emission reductions. For each there are strict criteria for verifying their actual sustainability.

In May 2018, the Commission also published the so-called. Sustainable Finance Package, an initial package of legislative proposals that includes:

- the proposal for what became the Sustainable Finance Disclosure Regulation (SFDR), i.e., the regulation of sustainability disclosure obligations on financial operators, adopted in November 2019 by EU Regulation No. 2019/2088;
- the proposal to amend the Benchmark Regulation (EU Regulation No. 2016/1011), with the provision of two new climate change-related benchmark indices, adopted in November 2019;
- the proposal for what became the Taxonomy Regulation, i.e., the general framework for the classification of sustainable economic activities, adopted on June 22, 2020, by EU Regulation No. 2020/852.

The mosaic framework is completed in the years to date with further interventions.

On December 11, 2019, the European Commission's Green Deal Mandate Program is approved, which aims to mobilize €1 trillion over 10 years.

On June 22, 2020, EU Regulation No. 2020/852 is approved, forming the Taxonomy Regulation for Sustainable Finance, and introducing the 'system of Single classification' to define economic activities Sustainable.

On July 22, 2020, Next Generation EU is approved, aiming to raise €750 billion in financial markets for post-Covid revitalization.

On March 10, 2021, European Regulation 2019/2088 (Sustainable Finance Disclosure Regulation SFDR), the first part of the European Sustainable Finance Plan, entered into force. The entry into force of the regulation makes it possible to standardize reporting requirements on financial products by all market participants, combating the worrying phenomenon of financial greenwashing (which transposes the risk of greenwashing, i.e., the false presentation of an image of a company committed to the environment, to the level of investment products).

On April 21, 2021, a Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC, and Regulation (EU) No. 537/2014 and introducing new legislation for more reliable and comparable reporting of non-financial corporate information is presented.

On Dec. 14, 2022, Directive (EU) 2022/2464 of the European Parliament and of the Council amending Regulation (EU) No. 537/2014, Directive 2004/109/EC, Directive 2006/43/EC, and Directive 2013/34/EU regarding corporate sustainability reporting is approved.

3_THE EUROPEAN TAXONOMY THE ISSUANCE OF BTP GREEN

In the light of the relevant regulatory framework, the expression 'European taxonomy' refers to the classification, made on an EU basis, of economic activities that can boast the status of 'sustainable' activities. The purpose of the European taxonomy is to guide the choices of investors and businesses in view of the transition to economic growth free of negative environmental and climate consequences, as well as, as mentioned above, to prevent misleading or even false information from circulating in the market that can fuel the phenomenon of financial greenwashing.

The taxonomy, as it was indicated by the TEG at the time of publication of the draft regulation fulfils the role of *«a practical guide for policymakers, businesses and investors on how to invest in economic activities that contribute to having an economy that does not negatively impact the environment [...] however, it is not a mandatory list of economic activities in which to invest, nor is it a list of mandatory requirements for public investments, nor is it a list of mandatory environmental performance requirements for companies or financial products»*.

It is symptomatic that the same document also specifies, what Taxonomy is not:

- A mandatory investor list of economic activities in which to invest;
- A list of mandatory requirements for public investments;
- a list of mandatory environmental performance requirements for companies or financial products.

THE TAXONOMY IS:	THE TAXONOMY IS NOT:
▪ a transparency tool based on a classification system translating the EU's climate and environmental objectives into criteria for specific economic activities for private investment purposes	▪ a mandatory list of economic activities for investors to invest in ▪ a mandatory requirement for public investment ▪ a mandatory requirement on environmental performance for companies or for financial products

Ultimately, the European taxonomy responds to the need to create from scratch a uniform language with which to refer to the sustainability of different production activities and is a counterbalance to the new regime of production activities and is a counterbalance to the new regime of corporate reporting that addresses the need to increase the availability of ESG information through enhanced disclosure requirements on companies, both financial and non-financial.

These criteria also answer practical questions such as what activities can aspire to be defined as environmentally sustainable? Under what conditions? Since they set out in detail the thresholds that must be met for any activity to be defined as environmentally sustainable.

Concomitantly, these two lines of action-identified in the 2018 Action plan on sustainable finance-contribute to achieving greater transparency in financial markets to enable investors to make more informed investment decisions based on more and more accurate information and anticipate what is envisaged in the third pillar of the Action plan, which intends to give concrete implementation to these decisions, enabling financial resources to be channelled toward activities that can achieve European environmental goals through the provision of appropriate instruments.

Among these initiatives undoubtedly can be noted the use of State Green Bonds, which on the basis of the Taxonomy has identified, thanks to the formation of an 'Interministerial Committee for the monitoring and publication of the information necessary for the purpose of issuing Green Bonds', among the activities carried out by the Public Administration and indicated in the State Budget in the four-year period 2018-2021 those susceptible to financing in the financial markets.

In adherence to the Green BTP Green Bond Framework (GBF) issued on February 25, 2021, six categories of use of such finance were identified by redistributing them into the following topics:

1_ Renewable sources for electricity and heat generation
2_ Energy efficiency
3_ Transportation
4_ Pollution prevention and control and circular economy
5_ Protection of the environment and biological diversity
6_ Research [6]

Referring to the expenditure allocations indicated in the budget chapters of the various ministries, the disbursements made for each year of the period under consideration were grouped by homogeneous purpose and framed within the six categories.

In March 2021, the Italian state entered the green bond market for the first time by launching the BTP Green 2045, of which two tranches were issued with a total nominal value of 13,500 million euros and a countervalue at issue prices of 13,265.13 million euros.

The first issuance achieved a record number of applications in the inaugural sovereign Green Bond issues in Europe with participation of about 530 investors, more than half of them ESG, for a total demand of more than 80 billion euros.

The interest from the market was also confirmed when the second tranche was reopened in October 2021, with the participation of about 350 investors, almost half of them ESG investors [7].

Several tranches of smaller amounts also started in 2022 and 2023, however, these also produced results of significant interest.

6 With reference to this specific sector, the expenditure items included in the Italian state budget were taken into consideration, on research characterized by a broad-spectrum evolution of knowledge and technologies, which are difficult to sustain by private entities that cultivate sectoral interests. A significant part of these research expenses concerns the study of environmental phenomena and problems and the identification of technologies and projects aimed at increasing sustainability in this area.
Public research is often hinged in centers and institutes of a permanent nature and is carried out continuously over time, although there is no shortage of specific projects on which it may be directed from time to time. Thus, the related operating expenses generally allow for the regular development of this type of activity. The value of contributions on the state budget converted into Green Bonds amounts to about 1 billion 251 million for research.
The specific data are in the Allocation and Impact Report for BTP Green 2022 published by the Ministry of Economy and Finance (MEF) in May last year. The report can be read online: https://www.dt.mef.gov.it/export/sites/sitodt/modules/documenti_it/debito_pubblico/btp_green_post_emissioni/Rapporto-2022-Allocazione-e-Impatto-BTP-Green-13.05.2022.pdf, p. 31.

7 See, again, the official data given in the MEF Report op. cit., p. 3.

4_REGULATION (EU) 2020/852

From a strictly regulatory point of view, the main reference on taxonomy is Regulation (EU) 2020/852 of the European Parliament and of the Council of June 18, 2020, on the establishment of a framework to encourage sustainable investment and amending Regulation (EU) 2019/2088.

The Regulation first identifies the following environmental and climate objectives to which the Taxonomy should aspire:

1_ climate change mitigation;
2_ adaptation to climate change;
3_ sustainable use and protection of water and marine resources;
4_ transition to circular economy, with reference also to waste reduction and recycling;
5_ pollution prevention and control;
6_ protection of biodiversity and the health of eco-systems.

The establishment of these objectives is prodromal in view of the definition of eco-friendly activities. In fact, only activities that contribute positively to at least one of the six environmental objectives which do not produce negative impacts on any other objective (*Do No Significan Harm* DNSH); which are carried out in compliance with minimum social guarantees (e.g., those set out in OECD guidelines and UN documents).

It is then left to the European Commission to adopt a series of delegated acts to clarify the technical criteria under which economic activities can contribute to the environmental and climate objectives of the taxonomy.

With a view to greater *enforcement* of the framework, according to the regulation, companies subject to the Non-Financial Reporting Directive, institutional investors, and financial advisers will have to provide information on their activities and products according to the taxonomy within the following timeframe: from January 1, 2022 (with reference to the previous fiscal year, i.e., the year 2021) for activities that contribute to the goals of mitigation and adaptation to the climate change; from January 1, 2023 (for FY 2022) for activities contributing to the other four goals.

In a first step, in fact, by 2023 the taxonomy and technical criteria covered only the first two of the six environmental and climate objectives. It is specified in the Regulations what are «*the technical screening criteria under which specific economic activities can contribute substantially to climate change mitigation* (climate change mitigation) *and climate change adaptation* (climate change adaptation) *and to determine whether those* *economic activities cause significant harm to any other relevant environmental objective».*

Regarding the scope of application, it is clarified in Article 1 that the Regulation is effective with respect to member state and Union measures that include requirements about the issuance of environmentally sustainable financial products, market participants sustainable financial products, market participants financial and non-financial reporting requirements.

Special attention is paid to environmental objectives.

In this regard, the cases in which an economic activity causes significant harm to climate change mitigation and adaptation and environmental resource use are expressly clarified:

1_ if the activity leads to significant greenhouse gas emissions;
2_ if the activity leads to a worsening of adverse effects of current climate and projected future climate on itself or people, nature or assets;
3_ if the activity harms the good status or good ecological potential of water bodies, including surface and groundwater.

Companies are required to adopt 'minimum safeguards', i.e., procedures that are in line with the OECD Guidelines for Multinational Enterprises and the United Nations Guiding Principles on Business and Human Rights, including the principles and rights set out in the eight core conventions identified in the International Labor Organization's Declaration on Fundamental Principles and Rights at Work and the International Bill of Human Rights.

In implementing these procedures, enterprises abide by the «*Do No Significant Harm – DNSH» principle.*

The main advantage for companies is to have a legal framework to improve their business and make it sustainable. Companies have a set of goals to implement, allowing them to make far-reaching changes. In this way, they can clearly demonstrate their commitment to the environment.

In turn, companies can attract investors interested in sustainability. This allows them to raise capital from new and more diversified sources, helping them to improve their business and continue to grow.

In addition, companies improve their internal organization, thanks to the guidance of criteria used in the Taxonomy that simplify decision-making and planning, avoiding risks and seizing opportunities.

Also, of great impact is bound to be the platform on sustainable finance that has been established by the European Commission.

This platform is composed of representatives from the European Environment Agency, the European Supervisory Authorities - ESAs, the European Investment Bank; the European Union Agency for Fundamental Rights; experts representing relevant private sector stakeholders; experts representing civil society; experts appointed in a personal capacity with knowledge and proven experience in the areas covered by the regulation; and experts representing academia.

The platform is responsible for advising the Commission on the development, analysis, and impact of sustainability-relevant criteria and monitors application trends with a view to proposing changes to the existing Taxonomy mechanism.

In June 2021, the EU Taxonomy Compass was, in addition, published, which, as the name implies is intended to be a real 'compass' for approaching the Taxonomy, as it is a digital guide to facilitate access to the contents of delegated acts with the technical criteria of the Taxonomy of Sustainable Economic Activities.

However, the concrete scope of application of the Regulation is inextricably linked to the Commission's implementation of a series of delegated acts to the identification of benchmarks. With this point of view, it should be noted that on July 6, 2021, the Commission issued the Supplementary Delegated Act to Article 8 of the Regulation, which specifies the content, methodology, and presentation of the information that financial and non-financial firms must report on the share of economic activities that are aligned with the EU Taxonomy.

Previously, in April 2021, the Commission approved the first delegated act on the climate aspects of the EU Taxonomy (Climate Delegated Act), adopted on June 4, 2021, which defines the technical criteria by which to identify economic activities that can make a substantial contribution to the first two objectives of the Green Taxonomy: climate change mitigation and climate change adaptation.

5_ CONCLUDING REMARKS

Turning to some concluding thoughts, the current regulations cover only 13 sectors and do not include some important industries, such as agriculture. For the excluded sectors, there are very few incentives for reporting under the regulatory framework and this limits the impact these regulations can have in the short term.

Then, in the European Commission's long work to define sustainable finance, there is certainly room for improvement regarding environmental criteria, but most importantly, the Taxonomy will need to be expanded to include social criteria (one of the 3 key factors of ESG, *environmental, social, governance*).

It is not enough to specify that minimum safeguard thresholds in the social sphere will have to be met alignment with the OECD Guidelines for Business to the UN *Guiding Principles on Business and Human Rights*. Working on this aspect is the Platform for Sustainable Finance, which is working on drafting social criteria to be integrated with environmental criteria in the definition of sustainable activities.

A critical point of the Regulation is also the sanctioning apparatus, given that Article 22, to ensure compliance with the Regulation, refers to member states the adoption of rules on measures and sanctions, which should be effective, proportionate, and dissuasive.

The absence, at present, of a sanctioning system, certain and effective, risks in fact, both to configure an important obstacle to the achievement of the objectives of the taxonomy, and to create confusion in the single market due to the provision of different sanctions from country to country.

The next *step*s must therefore consist of the development of new criteria and delegated acts (in particular, the approval of the delegated act covering the remaining objectives is needed, with a view to having them enter into force before the end of the legislative term in 2024), on the one hand, and the identification of more stringent sanctioning measures, on the other. In fact, only through clarity of the regulatory framework and adequate sanction enforcement can a *green* and sustainable transition be concretely brought to life that it is free of settlement costs and bankruptcies.

Finally, some food for thought regarding the not always unambiguous agreement on technical criteria: the example of Gas and Nuclear are symptomatic.

In February 2022 at the time of the presentation of the second delegated act (which includes points 3 to 6 those not included in the first delegated act: the sustainable use and protection of water and marine resources; the transition to the circular economy, with reference also to waste reduction and recycling; pollution prevention and control; and the protection of biodiversity and the health of eco-systems) the issue of the highly contested definition decision for Gas and Nuclear came up. The proposal for months literally split the European Union in two, with rain of criticism coming from both the European Parliament and the Council, which brings together the member states.

At the end, however, at its session on July 6, 2022, the Parliament could not find a majority to approve the motion tabled to exclude these two sources from being included among the eco-sustainable economic activities, ultimately allowing the delegated act on the Commission's taxonomy to continue the *process* with the inclusion among the activities capable of being deemed sustainable by the taxonomy criteria these two cases.