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Sustainable Finance and the EU Taxonomy Regulation – Hype or Hope?

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EBI/EUSFIL Young Scholars Writing Competition

"The financial sector's contribution to achieving ESG goals"

Sustainable Finance and the EU Taxonomy Regulation – Hype or Hope?

Marleen Och[*]

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[**] An updated and modified version of this paper can be found here: Marleen Och, "The EU Taxonomy Regulation and the prevention of greenwashing", in Kern Alexander, Matteo Gargantini and Michele Siri (eds) "The Cambridge Handbook of EU Sustainable Finance - Regulation, Supervision and Governance" (forthcoming).

ABSTRACT

The European Commission has significantly increased its ambitions in regulating sustainable finance with its 2018 Action Plan "Financing sustainable growth". One of the proposed Regulations, which has been adopted in 2020, is the Taxonomy Regulation. It builds the core of the action plan, by providing definitions to determine whether an economic activity is environmentally sustainable and therefore suitable for a sustainable investment. While most stakeholders agree that the lack of common definitions poses several difficulties and hampers the progress on sustainable finance, the solution found in the form of the Taxonomy Regulation is not uncontested. Concerns include its usability, especially in light of the available data and the accompanying costs, and the need for a more conclusive taxonomy, which also covers less and non-sustainable economic activities. This paper briefly outlines the structure of the Taxonomy Regulation itself, highlights the main points of debate and recent developments and suggests some adjustments, in particular the need for an extension of the Taxonomy in order to prevent "greenwashing".

A. *Introduction*

The EU needs to radically and quickly transform its economy if it wants to meet the climate goals it set itself.[1] One crucial tool for change that policymakers have identified is the reformation of the financial system towards sustainability. The European financial sector manages over €100 trillion in assets and can therefore contribute significantly to reach the EU's climate goals by shifting assets towards environmentally friendly companies and activities.[2]

To include sustainability in its legal framework governing the financial sector, the EU released an Action Plan for financing sustainable growth in 2018.[3] This paper will discuss one of the core proposals of this action plan, the Taxonomy Regulation.[4] This Regulation, which entered into force on 12 July 2020, is the first unified EU-wide classification system, introducing standard definitions of what qualifies as an environmentally sustainable activity for investment purposes.[5] To prevent divergences within the internal market, these standards must be applied by all Member States that wish to further regulate sustainable finance as well as by financial market participants, when working with sustainable financial products.[6] Coherence will also be achieved in relation to benchmarks, labels and standards,[7] whose underlying framework and definitions can no longer differ between Member States, preventing that uncoordinated national actions could place barriers within the capital markets. This unified approach should support the uptake of sustainable finance in the financial sector in Europe, while easing the task for investors to assess the environmental impact of an investment. In particular it protects the integrity and the trust in sustainable financial products by allowing investors to compare and evaluate them, thereby mitigating the risk of greenwashing.[8]

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[1] The current EU Climate Law sets the long-term goal of climate neutrality by 2050, next to an emission reduction of at least 55% by 2030. The political agreement is awaiting formal adoption. *European Commission,* "Amended proposal for a Regulation on establishing the framework for achieving climate neutrality and amending Regulation (EU) 2018/1999 (European Climate Law)".

[2] *European Commission*, "Factsheet: Financing sustainable growth", 2019, p. 2.

[3] *European Commission*, "Action Plan: Financing Sustainable Growth", 2018.

[4] Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 (Taxonomy Regulation). The other main legislative proposals that emerged from the identified actions are related to low-carbon benchmarks, Regulation (EU) 2019/2089 amending Regulation (EU) 2016/1011 as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks (Climate Benchmarks Regulation) as well as the enhanced disclosure of sustainability aspects by financial market participants, Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector (Sustainable Finance Disclosure Regulation/SFDR).

[5] *European Commission*, "Action Plan: Financing Sustainable Growth", 2018, p. 4. While sustainable finance usually includes all three ESG criteria (environmental, social and governance), priority was given to the environmental aspect. There are however plans to extend this and develop as full Taxonomy for social and governance criteria at a later stage, see Article 26 Taxonomy Regulation.

[6] Article 1 Taxonomy Regulation.

[7] The standard EU-level definitions in the Taxonomy Regulation will be the basis of the EU Green Bond Standard: *Technical Expert Group on sustainable finance*, "Report on EU Green Bond Standards", 2019; *European Commission*, "Development of EU Ecolabel criteria for Retail Financial Products", 2019.

[8] Greenwashing refers to the practice of gaining an unfair competitive advantage by marketing or labelling a financial product as green or environmentally friendly, when in fact basic environmental standards have not been met, see recital 11, Taxonomy Regulation . For a longer discussion of greenwashing, see section D.I.3.

Additionally, the comparability across Member States will strengthen the trust in cross-border investments and builds a base for other EU legislation in the field of sustainable finance, regarding disclosure, labelling and prudential rules and could serve as an example for other legislators internationally, aiming to regulate this field.[9]

Despite those potential advantages, the Taxonomy is not uncontested. While some sides argue that the Taxonomy goes too far and places an undue burden on companies and financial market participants wanting to comply with it, others fear it might not reach far enough and only regulate a small niche green market rather than mainstreaming sustainable finance. Criticism further evolves around the specific activities covered or not covered, such as nuclear energy or gas, the availability of necessary data and its reporting, the inclusion of further transitional activities and the extension to all three ESG criteria. Another important topic for debate is the extension of the Taxonomy to also include significantly harmful activities, thereby creating a scale of environmental friendliness to allow for a clearer distinction and avoid possible misuse for greenwashing.

Following an overview of the Taxonomy's framework (B.), the most critical points of this debate will be addressed in the Analysis (C.) of this paper.

B. Framework of the Taxonomy Regulation

The Taxonomy Regulation sets out four general criteria an economic activity must adhere to if it wants to be environmentally sustainable (I). It also identifies and provides a framework for six potential environmental objectives and different types of economic activities (II) contributing to those objectives. The use of the Taxonomy Regulation is mandatory for several groups, including Member States, financial market participants and certain companies (III). In addition, the Taxonomy Regulation also provides certain rules on disclosure and modifies a number of obligations in the Sustainable Finance Disclosure Regulation (SFDR)[10] and sets up a specific governance structure for the development of technical criteria (IV).

I. Criteria for environmentally sustainable activities

The cornerstone of the Taxonomy Regulation consists of the four criteria[11] an activity has to fulfil to be considered environmentally sustainable: (1) the activity has to contribute substantially to one or more of six environmental objectives[12] (2) while at the same time it cannot significantly harm any of the other environmental objectives.[13] (3) The activity must be

[9] *European Commission*, "Action Plan: Financing Sustainable Growth", 2018, p. 4
[10] Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector (Sustainable Finance Disclosure Regulation/SFDR).
[11] Article 3 Taxonomy Regulation.
[12] Article 9 Taxonomy Regulation.
[13] Article 17 Taxonomy Regulation.

carried out in compliance with minimum international social and labour standards[14] and (4) must comply with the technical screening criteria related to each of the environmental objectives. Those four criteria are discussed in more detail below.

1. *Contribute substantially to an environmental objective*

In order for an activity to be taxonomy-compliant, it first has to contribute substantially to the achievement of at least one of six environmental objectives. Those environmental objectives are climate change mitigation, climate change adaptation, 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. Special attention has been dedicated to the first two criteria, while the technical standards for the other four are still mainly under development. For each of these objectives, the Taxonomy Regulation further outlines when the threshold of a substantial contribution is met. The criteria differ according to the environmental objectives at question, as there is no uniform definition of "substantial" that can be applied to every activity. Those specific thresholds are defined depending on the objective, industry and activity, in the Delegated Acts.[15]

A substantial contribution to climate change mitigation is made when the activity either avoids or reduces the emission of greenhouse gases or if it removes greenhouse gases, for example by strengthening carbon sinks such as forests. These reduction targets are aligned with the EU's Green Deal and emission targets for 2030 and 2050.[16] For the sector of electricity generation, an over-arching, technology-agnostic emissions threshold of 100g CO2e/KWh is applied.[17] In order to reach net-zero emissions by 2050, the threshold will be reduced every 5 years. For an activity in the energy generation sector to significantly contribute to the goal of climate mitigation, it must currently meet the threshold of 100g CO2e/KWh and if the activity shall go on beyond 2050, it must technologically be capable to reach net-zero emissions.[18]

Such clear and quantitative thresholds can however only be applied in regard to some of the environmental objectives. For others, a more nuanced approach is necessary to establish the threshold for significant contribution. The environmental objective of climate change

[14] Article 18 Taxonomy Regulation.

[15] The first set of Delegated Acts were adopted 04 June 2021 and 06 July 2021, with the remaining ones scheduled for 2022. The technical screening criteria will have to be updated and thresholds tightened over time. See *European Commission*, "Commission Delegated Regulation (EU)…/... of 4.6.2021 supplementing Regulation (EU) 2020/852 of the European Parliament and of the Council by establishing the technical screening criteria for determining the conditions under which an economic activity qualifies as contributing substantially to climate change mitigation or climate change adaptation and for determining whether that economic activity causes no significant harm to any of the other environmental objectives", further on referred to as "Delegated Regulation of 4.6. 2021".

[16] *European Commission*, "Delegated Regulation of 4.6.2021 – Explanatory Memorandum", p. 1.

[17] *European Commission*, "Delegated Regulation of 4.6.2021 – Explanatory Memorandum", p. 4.

[18] *European Commission*, "Delegated Regulation of 4.6.2021 – Explanatory Memorandum", p. 4; *Technical Expert Group on sustainable finance (TEG)*, "Taxonomy Technical Report June 2019", p. 232.

adaptation aims at climate-change related risk reduction or adverse impact reduction through the economic activity in question, while not increasing the risk for other people, nature and assets. In order for an activity to be more climate-resilient, it must substantially reduce either the adverse impact itself or all material physical climate risks, to the extent possible and on a best effort basis. To do so, monitoring and assessment of climate projections and industry-related sensitivities must be carried out.[19]

The Delegated Acts specifying the requirements for the remaining four criteria are still under development.[20]

2. Do no significant harm

In order for an activity to comply with the Taxonomy Regulation, it cannot significantly harm any of the other environmental objectives.[21] This requirement is further specified for each of the six environmental objectives.[22] Even if an activity significantly strengthens several environmental objectives, it is not eligible under the Taxonomy Regulation if it causes significant harm to another one. The objective of climate change mitigation for example is significantly harmed by an activity when it leads to significant greenhouse gas emissions. For the energy sector this threshold is currently set at 270g CO2e/kWh.[23] These thresholds have to establish a balance in order to ensure that very harmful activities are not included under the Taxonomy Regulation, while at the same time avoiding that environmental activities which have some negative impact on another level are not disqualified too easily.

3. Social minimum standards

The Taxonomy Regulation focuses on environmental objectives, even though sustainable finance in general also includes social and governance aspects. While priority was given to the environmental part, in order to qualify as sustainable under the Taxonomy Regulation the minimum requirements concerning social standards should nonetheless be ensured by complying with international human and labour rights principles. The initial Commission proposal therefore included safeguards related to the eight fundamental conventions identified in the International Labour Organisation's declaration on Fundamental Rights and Principles at Work. Those include standard labour rights such as prevention of forced labour, the freedom of association and workers' right to organize and collectively bargain, equal pay for men and

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[19] *European Commission*, "Delegated Regulation of 4.6.2021 – Explanatory Memorandum"; *TEG*, "Taxonomy Technical Report June 2019" , p. 386f.
[20] *European Commission*, "EU Taxonomy for sustainable activities", 2021, https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en, accessed 01.09.2021.
[21] Article 3(b) Taxonomy Regulation.
[22] Article 17 Taxonomy Regulation.
[23] *European Commission*, "Delegated Regulation of 4.6.2021 – Annex II", p. 103f.

women and prevention of child labour.[24] During the negotiations between the co-legislators, an extension of the scope was agreed upon, adding three international human rights guidelines to the list of minimum safeguards: the OECD Guidelines for Multinational Enterprises, the UN Guiding Principles on Business and Human Rights and the International Bill of Human Rights.[25] Through the addition of those guidelines, the scope was widened significantly, as they not only include strict social and labour standards, but also broader provisions.[26] Furthermore, a sub-group of the Platform on Sustainable Finance is working on the possible development of a full social taxonomy.[27]

4. *Technical screening criteria*

While the Taxonomy Regulation provides the broader framework, the Delegated Acts define the detailed criteria, which must be based on scientific evidence, respect the principle of technological neutrality, build on existing market practices and EU legislation and take into account life cycle impacts.[28] The fact that an activity has to comply with these technical screening criteria is therefore not an additional criterion but rather specifies the other three criteria and how they can be met.

II. *Types of substantial contribution*

The Taxonomy Regulation allows for different ways an activity can substantially contribute to an environmental objective. The first category is a direct substantial contribution by the activity in question,[29] as illustrated under (I.). Alternatively an activity can be taxonomy-compliant if it does not meet the stringent criteria for a substantial contribution per se, but corresponds to the best performance available in the industry or sector at question.[30] Those transitional activities thereby broaden the coverage of the Taxonomy to provide incentives to enhance the performance in those highly emitting sectors. Lastly, the Taxonomy also covers activities which do not make a substantial contribution themselves but directly enable another activity to do so.[31]

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[24] See Article 13 of *European Commission,* "Proposal for a Regulation on the establishment of a framework to facilitate sustainable investment", 2018.
[25] *European Commission*, "Communication from the Commission to the European Parliament pursuant to Article 294(6) TFEU concerning the position of the Council on the adoption of the Taxonomy Regulation", 2020, p. 4.
[26] See for example on taxation: *OECD,* "OECD Guidelines for Multinational Enterprises", 2011, Chapter XI.
[27] *Platform on Sustainable Finance*, "Draft Report by Subgroup 4: Social Taxonomy", 2021.
[28] Article 19 and Article 23 Taxonomy Regulation .
[29] See for example Article 10 (1) Taxonomy Regulation.
[30] See for example Article 10 (2) Taxonomy Regulation.
[31] Article 16 Taxonomy Regulation.

By adding these two alternatives to the direct significant contribution, the scope of the Taxonomy Regulation was significantly broadened in the political agreement and the question of further broadening the category of transitional activities is being discussed. [32]

1. Enabling activities

An economic activity can be taxonomy-compliant even if it in itself does not make a contribution to one of the environmental objectives, but instead directly enables other activities to do so. [33] While the enabling activity itself might be "neutral", it still falls under the Taxonomy Regulation as it provides low-carbon activities with the necessary resources to enable their activity. This can include for example research and development, the manufacturing for renewable energy technologies such as wind turbines, or additional infrastructure, such as the installation of energy-efficient boilers in buildings or the installation of train tracks. [34]

In order to ensure that the scope is not broadened too much, enabling activities must not lead to a lock-in in assets that undermine long-term environmental goals, considering the economic lifetime of those assets, and they must have a substantial positive environmental impact on the basis of lifecycle considerations.[35] The underlying idea behind those safeguards is to allow for deviation from direct low-carbon activities, but always with the goal of keeping activities as sustainable as possible. While for now a specific enabling activity might be the overall best option, new technological developments could quickly change this, which is why the Taxonomy Regulation wants to avoid the long-term lock-in of those assets.[36]

2. Transitional activities

Transitional activities are not providing a substantial contribution to e.g. climate change mitigation, nor do they enable another activity to do so.[37] They can still considered taxonomy-compliant because they are more environmentally friendly than the industry's standard. The rationale behind this is to promote the most environmentally friendly options within certain industries, which are critical to the economy, but urgently need to reduce their environmental

[32] *European Commission*, "Communication from the Commission to the European Parliament pursuant to Article 294(6) TFEU concerning the position of the Council on the adoption of the Taxonomy Regulation", 2020, p. 4: *Platform on Sustainable Finance,* "Transition Finance Report March 2021".
[33] Article 16 Taxonomy Regulation .
[34] *European Commission*, "Delegated Regulation of 4.6.2021 – Explanatory Memorandum", p. 14f.; *TEG*, "Taxonomy Technical Report June 2019", p. 33f.
[35] The term 'lock-in' in this context refers to the effect of certain high-emitting activities to persist, even when less emitting alternatives are already available, and hamper these from entering the market. This happens usually when an activity requires high initial investments but then is relatively inexpensive to be used afterwards e.g. the construction of a nuclear power plant. This initial effect tends to get reinforced through political, market and social factors, see: *TEG*, "Final report March 2020", p. 20.
[36] *European Commission*, "Delegated Regulation of 4.6.2021 – Explanatory Memorandum*",* p. 17; *TEG*, "Final report March 2020", p. 20.
[37] Article 10(2) Taxonomy Regulation.

impact.[38] One example that be given is the production of cement, which is very carbon-intensive and yet essential to the building industry. If all cement production would be excluded from the Taxonomy Regulation, as there is no low-carbon method yet, there would be fewer incentives for the industry to invest in the technology with the best environmental performance, which is especially crucial for highly emitting and economically important sectors. Therefore, an activity which corresponds to the best environmental performance within a highly emitting industry can be taxonomy-compliant in order to incentivize a change in that industry.[39] In order not to widen the scope too much and thereby undermining the overall goals of the Taxonomy Regulation, the transition category does not apply to those fields where other, more environmentally friendly alternatives exist as a commercially feasible alternative.[40] Further, the activity's environmental advantages must be substantial compared to the industries average. The threshold for what is substantial, defined in the technical screening criteria, will be adapted and strengthened over time. Lastly, the activity must not result in a lock-in into carbon intensive assets or processes.[41]

III. Scope

1. Mandatory users

The Taxonomy Regulation itself includes three groups of mandatory users in its scope: the EU and its Member States, financial market participants offering financial products, and certain large companies (undertakings subject to the obligations to publish a (consolidated) non-financial statement).[42]

For the EU or Member States, the Taxonomy applies to any legislative or other measures they might want to adopt, for example regarding labels or green bonds. These standards, mostly concerning requirements for financial market participants, need to be aligned with the Taxonomy. Member States cannot provide deviating definitions for environmental activities or objectives, but they can keep already existing labelling schemes in place or develop new ones, provided they comply or are made compliant with the Taxonomy Regulation.[43] The Taxonomy Regulation is therefore a common framework that ensures that the underlying definitions and requirements are the same, while still allowing the specifics to be filled in by initiatives coming from Member States or the industry itself.

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[38] *European Commission*, "Delegated Regulation of 4.6.2021 – Explanatory Memorandum*",* p. 9fra.
[39] *Platform on Sustainable Finance,* "Transition Finance Report March 2021"; *TEG*, "Final report March 2020", p. 20.
[40] Article 10(2) Taxonomy Regulation.
[41] Article 10(2) Taxonomy Regulation.
[42] Article 1(2) Taxonomy Regulation.
[43] Article 4 and recitals 11 and 14 Taxonomy Regulation.

Financial market participants[44] themselves need to apply the Taxonomy at the product level by disclosing which proportion of an investment, fund or portfolio[45] is taxonomy-aligned. The details are further regulated by the SFDR.

Besides Member States and financial market participants, certain companies also fall within the scope of the Taxonomy Regulation. The companies covered are those which are subject to the requirement to publish non-financial statements according to the Non-Financial Reporting Directive (NFRD).[46] They must apply the Taxonomy at the entity level, disclosing which of their activities are following environmental objectives and which policies they implement in relation to environmental protection.[47] This disclosure covers the proportion of their turnover, their capital expenditure and their operating expenditure related to assets which qualify under the Taxonomy Regulation.[48] The disclosed information is necessary in order for financial market participants to likewise disclose the alignment of their products. Since not only large companies are included in those investment products, voluntary disclosure is likewise encouraged for SME's.

[44] In its definition of financial market participants, the Taxonomy Regulation refers to the Disclosure Regulation. According to Article 2 (1) of the Disclosure Regulation (fn. 4), financial market participants are the following: (a) an insurance undertaking which makes available an insurance-based investment product (IBIP); (b) an investment firm which provides portfolio management; (c) an institution for occupational retirement provision (IORP); (d) a manufacturer of a pension product; (e) an alternative investment fund manager (AIFM); (f) a pan-European personal pension product (PEPP) provider; (g) a manager of a qualifying venture capital fund registered in accordance with Article 14 of Regulation (EU) No 345/2013; (h) a manager of a qualifying social entrepreneurship fund registered in accordance with Article 15 of Regulation (EU) No 346/2013; (i) a management company of an undertaking for collective investment in transferable securities (UCITS management company); or (j) a credit institution which provides portfolio management.

[45] In its definition of financial products, the Taxonomy Regulation refers to the Disclosure Regulation. Financial products according to Article 2 (12) of the Disclosure Regulation (fn. 4) are: a portfolio managed in accordance with point (6) of the Article; (b) an alternative investment fund (AIF); (c) an IBIP; (d) a pension product; (e) a pension scheme; (f) a UCITS; or (g) a PEPP. Portfolio management as a financial product is specified as "managing portfolios in accordance with mandates given by clients on a discretionary client-by-client basis where such portfolios include one or more financial instruments" in Article 4(8) of Directive 2014/65/EU of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (MiFID II). For difficulties related to this classification, see *EBA, ESMA, EIOPA*, "Joint Consultation Paper ESG Disclosure", 2020, p. 12.

[46] Article 19a and 29a Directive 2014/95/EU amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups' of the amended Non-Financial Reporting Directive. This requirement only applies to large public-interest companies with more than 500 employees, covers about 11.000 companies in the EU, including most listed companies, banks and insurance companies.

[47] Article 19a and 29a Non-Financial Reporting Directive .

[48] Article 8 Taxonomy Regulation and the "Article 8 Reporting", see: Proposal for Delegated Acts, *European Commission*, "REGULATION (EU) …/... of 6.7.2021 supplementing Regulation (EU) 2020/852 of the European Parliament and of the Council by specifying the content and presentation of information to be disclosed by undertakings subject to Articles 19a or 29a of Directive 2013/34/EU concerning environmentally sustainable economic activities, and specifying the methodology to comply with that disclosure obligation", 2021.

2. Voluntary users and indirect impact

While the Taxonomy Regulation mainly targets the above-listed mandatory users, its relevance is not confined to the them. As the core of a wider framework on sustainable finance, the Taxonomy Regulation will find its way into other legislation, which applies to a broader scope of financial market actors. [49]

Not explicitly covered by the Taxonomy Regulation are retail banking products such as mortgages or loans, securitizations, venture capital or private equity. While they do not fall under the scope of mandatory users, they can still use the Taxonomy Regulation on a voluntary basis.[50] Credit institutions may for example use it when offering green loans or green project financing. Especially large international banking groups which cover a variety of activities may benefit from aligning all their activities under the same framework, as suggested in the Renewed Sustainable Finance strategy's pillar "Improving the inclusiveness of sustainable finance".[51] The framework established by the Taxonomy Regulation may further play a role in banking supervision. Following its Renewed Sustainable Finance strategy, the Commission in coordination with the ESA's, ESRB and the ECB will further analyse whether and how macro-prudential tools can address financial stability risks caused by climate change as part of an upcoming review of the banking macro-prudential framework.[52]

While the Taxonomy Regulation does not explicitly follow a cross-sectoral approach, its relevance for the wider financial law framework allows the direct or indirect application by the entire financial industry.

IV. Other provisions

1. Interplay with the Disclosure Regulation

The Taxonomy Regulation is one of several legislative acts that together form the EU's legislative approach to sustainable finance. While the main aim of the Taxonomy Regulation is to define what makes an activity environmentally sustainable, the SFDR provides harmonized requirements, inter alia, the mandatory disclosure of sustainability risks and adverse negative impacts of investment decisions on ESG factors for all investment products.[53] In addition, it imposes specific disclosure requirements for two types of sustainable financial products: those

[49] *Christos V. Gortsos*, "The Taxonomy Regulation: more important than just as an element of the Capital Market Union", EBI Working Paper Series, 16 December 2020, p.34.
[50] *TEG*, "Taxonomy Technical Report June 2019" , p. 60.
[51] *European Commission*, "Strategy for Financing the Transition to a Sustainable Economy", 2021, p. 15.
[52] *European Commission*, "Strategy for Financing the Transition to a Sustainable Economy", 2021, p. 14. *ECB*, "Guide on climate-related and environmental risks: Supervisory expectations relating to risk management and disclosure", 2020; *EBA* "Action Plan on Sustainable Finance", 2019.
[53] Article 6 and 7 Disclosure Regulation.

that have “sustainable investment” as their “objective“[54], and those that only “promote, among other characteristics, environmental or social characteristics”[55].

Financial market participants which offer such sustainable products are obliged to use the Taxonomy Regulation in their assessment and to disclose to what extend they use it. When only using the Taxonomy Regulation for parts of the portfolio which are sustainable investments[56], the financial market participant must disclose this partial use to make it transparent for investors which parts have been assessed against the Taxonomy Regulation.[57] The Taxonomy Regulation introduces further amendments to the SFDR, mainly seeking to align the overall framework of sustainability-related disclosure by financial market participants with the specifics of the Taxonomy Regulation.[58]

2. Governance structure

As the Taxonomy Regulation itself can only provide a broad framework of what is and is not environmentally sustainable, power is delegated to the Commission to establish technical screening criteria in the form of Delegated Acts. Whether the Taxonomy Regulation can accomplish its goals therefore largely depends on how stringent and science-based those technical criteria are and how they will be adapted and tightened over time.

To ensure that the Commission is advised by a balanced group of experts when establishing these criteria, the Taxonomy Regulation establishes the so-called Platform as an advisory group to the Commission.[59] It is tasked with advising the Commission on the establishment of the technical screening criteria as well as possible updates regarding the need to develop further measures to improve data and usability of the technical screening criteria, the potential need to amend the Taxonomy Regulation and on addressing the other sustainability objectives such as social concerns or the extension of the Taxonomy.[60] Next to the Platform, the already established Member State Expert Group on Sustainable Finance advises the Commission and Platform on the appropriateness of the technical screening criteria established by them.[61]

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[54] Article 9 Disclosure Regulation.
[55] Article 8 Disclosure Regulation.
[56] Article 2(7) Disclosure Regulation.
[57] Article 5 and 6 Taxonomy Regulation.
[58] Article 25 Taxonomy Regulation, calling on the ESA’s do develop draft regulatory technical standards, see *EBA, ESMA, EIOPA*, ”Joint Consultation Paper ESG Disclosure”, 2020; see *EBA, ESMA, EIOPA*, ”Joint Consultation Taxonomy-related sustainability disclosures Draft regulatory technical standards with regard to the content and presentation of sustainability disclosures pursuant to Article 8(4), 9(6) and 11(5) of Regulation (EU) 2019/2088”, 2021.
[59] Article 20 Taxonomy Regulation.
[60] *European Commission,* “Platform on sustainable finance”, https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/overview-sustainable-finance/platform-sustainable-finance_en, accessed 26.08.2021.
[61] Article 24 Taxonomy Regulation.

3. Application

The Taxonomy Regulation will, in regard to the first and second environmental objective, apply as of 1 January 2022, and for the other objectives as of the 1 January 2023.[62]

The SFDR in principle applies as of 10 March 2021,[63] but some of the disclosure requirements linked to the Taxonomy Regulation have been aligned with the Taxonomy's application dates.[64] The non-financial statements falling under the NFRD will also have to follow the Taxonomy Regulation's framework as of 1 January 2022 and 1 January 2023.[65]

4. Ongoing developments

Since the entry into force of the Taxonomy Regulation on 12 July 2020, the Commission and the Platform have published a number of Delegated Acts and reports further developing and building on the Taxonomy.[66] In April 2021 the first climate Delegated Acts specified the technical screening criteria for climate change mitigation and adoption, and a Commission proposal for a Corporate Sustainability Reporting Directive aims to amend the existing NFRD.[67] It includes disclosure requirements for listed SME's, thereby extending the scope of direct Taxonomy applicants. In June 2021 the Commission published the Delegated Acts relating to Article 8 of the Taxonomy Regulation, which specify the disclosure requirements for financial and non-financial companies. Furthermore, the Commission published a proposal for EU Bond Standards, which build on the Taxonomy's framework, as well as a renewed Sustainable Finance strategy, which announces further developments of the Taxonomy Regulation.[68] Further steps for the Taxonomy include complementary Delegated Acts to cover industries and sectors not yet included, such as agriculture and some energy sectors, and possible actions based on the reports by the Platform to extend the Taxonomy.[69]

[62] Article 27(2) Taxonomy Regulation.
[63] Article 20 Disclosure Regulation.
[64] Article 25(5) Taxonomy Regulation
[65] Article 27(2) Taxonomy Regulation.
[66] *European Commission*, "EU Taxonomy for sustainable activities", 2021, https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en, accessed 01.09.2021.
[67] *European Commission,* "Proposal for a Directive amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting", 2021.
[68] *European Commission*, "Sustainable Finance Package", 2021, https://ec.europa.eu/info/publications/210421-sustainable-finance-communication_en, accessed 01.09.2021
[69] *European Commission*, "EU Taxonomy for sustainable activities", 2021, https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en, accessed 01.09.2021.

C. Analysis

While the Taxonomy Regulation is undoubtably a big step towards a coherent EU sustainable finance framework, important challenges remain. This part of the paper will analyse a number of those challenges and make a number of policy recommendations.

I. Challenges

The following paragraphs will highlight the main challenges the Taxonomy Regulation poses, such as the lack and availability of ESG data, the absence of a Taxonomy that includes all three ESG criteria and the remaining potentials for greenwashing.

1. Data gaps and costs

a. Lack of ESG related disclosure from companies

A first challenge lies in the availability of sustainability related data. The SFDR requires financial market participants to disclose specifics about their sustainable financial products. These financial actors will therefore need reliable and standardized data about each investment product's underlying economic activity in order to assess its compliance with the Taxonomy Regulation. However, only those companies bound by the NFRD will have to disclose environmental data on the necessary scale, and only as of 2022/2023.[70]

While disclosure for other companies is encouraged, it is not mandatory. When companies only provide limited or incomplete data, this poses a challenge for financial market participants, which might be amplified depending on the nature and structure of the financial product.[71] Smaller companies that are unable to provide the data themselves may simply be left out of financial market participant's considerations for certain financial products.

In other cases, the financial market participants will have to rely on their own data and/or third-party data providers, such as sustainability rating agencies. Once financial actors outsource their data gathering and assessment to rating agencies, the impact of those agencies increases significantly. Yet, there is a lack of transparency on how these ratings get established and their comparability, and the supervision and scrutiny applied to the agencies falls short compared to their growing impact.[72] Further hurdles may appear for gathering data from international

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[70] Initially the disclosure requirement for companies was foreseen for 2022, but now a fade-in procedure for 2022 will likely at least partially delay the actual mandatory disclosure until 2023, see: *European Commission,* "Proposal for a Directive amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting", 2021.

[71] *TEG*, "Taxonomy Technical Report June 2019", p. 71f.

[72] *Steven Maijoor*, European Securities and Markets Authority, "Sustainable financial markets: translating changing risks and investor preferences into regulatory action", 2020, p. 6; *European Commission and Environmental Resources Management (ERM),* "Study on sustainability-related ratings, data and research", 2021, https://op.europa.eu/en/publication-detail/-/publication/897bee11-509d-11eb-b59f-01aa75ed71a1/language-en, accessed 01.09.2021.

companies which are not bound by any EU law, as they do not have to disclose this information and the metrics the technical screening criteria refer to are often based only on EU standards.[73]

b. *Information on profitability and risks surrounding ESG investments*

With its sustainable finance package, the EU is nudging private investors to shift their capital towards green investments.[74] This political strategy is aligned with the EU's commitments for emission reduction, which would likely not be reachable without private funding. Available data on the profitability and risks of ESG investments however is still scarce.[75] The EU's clear goal is the transition to a green and circular economy, yet this needs to be balanced with other goals such as investor protection and financial stability.[76]

Though none of the EU's recent legislation forces any investors to invest "green", the intention to restructure large parts of the financial system to cater to green investments is very clear. The Taxonomy Regulation will likely be utilized as a baseline for many other policies, as recently seen with the use of the DNSH criterion for the "Next Generation EU" Recovery plan. [77] A common framework for what can be seen as an environmentally sustainable investment is the first necessary step in ensuring sufficient and comparable data on ESG investment. The creation of a Taxonomy was therefore needed. Yet it will take a few years until conclusions can be drawn from the upcoming disclosure, raising the question how to advance in the meantime. This lack of reliable information on the risks and profitability of ESG investments can therefore also be raised as a counterargument to further advancing the sustainable finance framework, including a broadened application of the Taxonomy Regulation.

c. *Cost of gathering data*

Gathering and analysing all the necessary data to prove compliance with the Taxonomy Regulation has economic implications for companies as well as financial actors, out of which many criticized the Taxonomy Regulation for being too detailed, complex and data-intensive.[78]

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[73] *European Commission*, "Delegated Regulation of 4.6.2021 - Annex I and II,", 2021.

[74] On the extend the EU is actually promoting sustainable investments through its policies, see: *Moritz Baer/ Emanuele Campiglio/Jérôme Deyris*, "It Takes Two to Dance: Institutional Dynamics and Climate-Related Financial Policies", 2021, Centre for Climate Change Economics and Policy Working Paper No. 384.

[75] *Harrison Hong/G. Andrew Karolyi/José A. Scheinkman*, "Climate Finance*",*33 REV. FIN. ST. 1011, 2020.

[76] *Dirk A Zetzsche/Linn Anker-Sørensen, "*Regulating Sustainable Finance in the Dark", 2021, EBI Working Paper Series 2021 No. 97, p. 42.

[77] See Art. 4a in: *European Commission*, "Proposal for a Regulation establishing a Recovery and Resilience Facility", 2021.

[78]*European Commission,* "Consultation on the renewed sustainable finance strategy", https://ec.europa.eu/info/consultations/finance-2020-sustainable-finance-strategy_en, accessed 14.10.2020.

On the other hand, poor or limited ESG data disclosure and assessment can quickly lead to market confusion and greenwashing, while common guidelines and methodologies provided by the legislator can help return some of the lost trust in sustainable finance.[79]

The disclosure and preceding gathering of data undoubtedly present themselves as additional costs to the companies and financial markets, but it is uncertain who will ultimately carry them. They could be entirely passed onto the end-investor, potentially making the sustainable financial product less competitive and therefore less attractive as an investment. [80] This effect is magnified depending on how much the "non-sustainable" actors will disclose. It might be more cost-efficient to disclose that a company or financial product is not compliant with the Taxonomy Regulation than to undergo an in-depth assessment of all its activities. If a significant number of actors chooses this path, the sustainable companies and financial actors would be the only ones actually conducting the costly and time-consuming assessment, though they might not get rewarded with more investments due to the cost of their analysis.[81] This would turn sustainable finance into a costly niche product, rather than making it mainstream as intended by the Taxonomy Regulation. This argument is often brought forward by supporters of a more flexible, market-based framework in contrast to the EU's stricter regulatory approach.[82] Contrasting voices on the other hand find that the Taxonomy with its extended scope including transitional and enabling activity is now so broad that it cannot truly aid in achieving the EU's climate targets. On the contrary, the goal of preventing greenwashing may have been missed, as current greenwashing practices on the markets are not prevented, but rather fall under the scope of the Taxonomy Regulation.[83]

Whether the Taxonomy Regulation is too broad or rather too narrow is therefore highly debated. Research estimates that under the current framework only about 5% of economic activities are in line with the Taxonomy.[84] The goal of the Taxonomy Regulation to allocate more capital to sustainable causes will not be reached by lowering the thresholds, as not requiring thorough assessment could lead to diverting and inconsistent application. Instead there need to be more incentives to companies to align their performance with the Taxonomy

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[79] *Michele Siri/Shanshan Zhu,* "Will the EU Commission Successfully Integrate Sustainability Risks and Factors in the Investor Protection Regime? A Research Agenda", Sustainability, 2019, 11, 6292, p. 18.

[80] Some fund may even over-charge, using the ESG-related disclosure and monitoring as a justification. Analysis of different ESG investment funds and their fees: *Dana Brakman Reiser/Anne M. Tucker,* "Buyer Beware: Variation and Opacity in ESG and ESG Index Funds", Cardozo Law Review, Vol. 41, 2020, p. 1999f.

[81] Certainly, other incentives to offer sustainable financial products remain, e.g. reputation, inclusion in an index for funds which are tracking Paris-alignment and EU transition benchmarks, EU Ecolabel, Green Bond qualification.

[82] *Karry Lai*, "High hopes for EU sustainable finance taxonomy", International Financial Law Review, 2019, p.1.

[83] *Frédéric Hache*, "Sustainable finance 2.0: The securitization of climate and biodiversity policies", Green Finance Observatory Policy Report, March 2020, p. 37f.

[84] *Adelphi and ISS ESG*, "European Sustainable Finance Survey", 2020, https://sustainablefinancesurvey.de/; *TEG*, "Taxonomy Technical Report June 2019", p. 92.

Regulation. Requiring detailed disclosure is necessary for the Taxonomy Regulation to work, even when it comes with an economic cost. To provide those incentives and avoid the potential unwarranted consequence of a niche product, an extension of the Taxonomy Regulation that obliges almost every company to apply it, is necessary, as argued in section II.3.

2. *Lack of a full ESG Taxonomy*

Further incoherence problems arise due to the absence of a full ESG taxonomy. The current Taxonomy Regulation only defines environmentally sustainable activities and ensures compliance with minimum social safeguards, but does not address social or governance aspects as independent criteria. This however does not reflect the market of sustainable financial products, where social, governance and environmental aspects are often interlinked and ESG financial products offered to investors. Furthermore, the EU Green Deal specifically states that the EU wants to achieve a just climate transition, leaving no person or place behind.[85] In light of EU values enshrined in Article 3 TEU or the UN SDG's themselves, a clearer commitment from the EU on social and governance standards can be expected and its nonexistence is causing difficulties for financial market participants, investors and EU institutions themselves. In lack of an ESG Taxonomy, the European Investment Bank had already adopted its own environmental standards and is currently aligning its sustainability awareness bonds eligibility criteria with the United Nation's Sustainable Development Goals.[86]

3. *Loopholes for greenwashing*

Critics argue that the due to its broad scope, the Taxonomy in its current composition actually fails to prevent greenwashing and instead includes more investments than under the traditional and currently criticised green investment criteria.[87] But even if the Taxonomy Regulation is effective at targeting greenwashing by introducing ambitious and science-based mandatory standards, it is not fully equipped against indirect greenwashing, which could easily occur with complex financial products.

Many "green" investment products will be layered and consist of several and different company's activities. It would be difficult for an investor to determine the level of sustainability of an investment when parts of a financial product are declared as taxonomy-compliant, but the rest remains undefined and could contain environmentally harmful activities. A financial product could be 50% taxonomy-compliant, while the remaining 50% could finance environmentally harmful activities. Yet, it could then be marketed as 50% taxonomy-compliant.

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[85] *European Commission,* "The European Green Deal", 2019, p. 16.
[86] *European Investment Bank*, "Sustainability taxonomy at heart of EIB engagement", Global Capital, 2020, p. 2.
[87] *Frédéric Hache*, "Sustainable finance 2.0: The securitization of climate and biodiversity policies", Green Finance Observatory Policy Report, March 2020, p. 37f.

Companies that do not contribute to sustainable causes nonetheless have an interest to be included in these "green" products in order to benefit from additional investments. If there is no "harmful" or "red" category, investors can easily be misled, and unsustainable activities can be hidden in complex financial products. In its current composition, the Taxonomy Regulation does not prevent this type of abuse of its own structure.

II. Policy proposals

Many of the above identified challenges can be mitigated or solved through the following policy recommendations.

1. Enhanced disclosure of ESG data

A large part of the data gap will be filled in time by more and more companies disclosing their sustainability information. To speed up and enhance this process, the Commission published a new proposal for a Corporate Sustainability Reporting Directive (CSRD), which will replace the current NFRD.[88] The scope of the CSRD is significantly wider, including all large companies, compared to only listed companies exceeding 500 employees. The scope furthermore includes a simplified reporting regime for listed SME's, thereby mitigating the above-mentioned risk that they might get excluded from investment portfolios altogether, as financial market participants want to facilitate their own disclosure. In order to limited the burden on them, other SME's and listed micro-enterprises are not included in the scope. They are however strongly encouraged to follow the simplified reporting regime on a voluntary basis. The Commission's reasoning being that disclosing ESG information will become a common practice in the following years and will be used as a basis for many other transactions, such as bank loans, and will be increasingly required by customers.[89]

All those companies complying with the CSRD, whether mandatory or voluntarily, will disclose data relevant for the Article 8 reporting under the Taxonomy Regulation, which currently refers to the NFRD. The data necessary for a consistent application of the Taxonomy will therefore be ensured through the new CSRD, as it will build on the Taxonomy categories of significant contribution and do no significant harm.[90] While the CSRD thereby mitigates the data gap problem, it will take several years until these provisions would enter into force, provided the CSRD proposal is agreed on at all. While a fade-in period is necessary in order for

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[88] *European Commission,* "Proposal for a Directive amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting", 2021.

[89] *European Commission,* "Proposal for a Directive amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting", 2021, p. 10f.

[90] *European Commission,* "Proposal for a Directive amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting", 2021, p. 16.

companies to adapt to these new requirements, it complicates the disclosure for financial market participants until then and hampers the research based on this data about the risks and profitability of ESG investments.

When it comes to the ESG rating market, clear legislation on the methodologies and mechanisms rating agencies have to apply is necessary to ensure a stable and reliable stream of data, which underpins the Taxonomy.[91] The Commission's renewed Sustainable Finance strategy addresses this issue under Action 4, as it intends to improve the comparability and reliability of ESG ratings. [92] Given the diverging models and practices ESG ratings are currently based on, this will likely be a challenge.[93]

Lastly, the problem related to data from international companies is not directly addressed through EU legislation, though some of the global initiatives the EU supports aim at developing globally accepted sustainability reporting standards.[94] In order for the Taxonomy Regulation to be workable for international portfolios, the screening criteria would need to be expanded or guidelines need to be offered for equivalent metrics outside of the EU. This step would ease portfolio assessment and enhance the use of the Taxonomy Regulation on a global scale. The overall harmonization of sustainable finance may further ease data availability concerns. A robust legislative framework in the EU might also be picked up as an example by other countries.

2. *Coherent and full ESG framework*

The sub-groups of the Platform which is working on the possible extension of the Taxonomy Regulation to include social and governance aspects proposed in its draft report to facilitate the process by aligning such a Taxonomy with already existing standards. These include the European Pillar of Social Rights, the European Social Charter, the EU Charter on Fundamental Rights and the European Convention on Human Rights.

Despite the added benefit of strengthening and supporting companies which respect and foster these rights and allowing for more transparency among ESG investment products, there are also downsides and obstacles to consider. For many social goals it is more difficult to create measurable quantitative criteria, compared to the science-based metrics used for the environmental Taxonomy.[95] Furthermore, many of the social goals actually do not fall into the

[91] Discussion by ESMA on the potential need for regulatory changes: *ESMA*, "Technical Advice to the European Commission on Sustainability Considerations in the credit rating market", 2019.
[92] *European Commission*, "Strategy for Financing the Transition to a Sustainable Economy", 2021, p. 16.
[93] *Florian Berg/ Julian Koelbel/ Roberto Rigobon,* "Aggregate Confusion: The Divergence of ESG Ratings." 2020, p. 8f.
[94] In that regard, the European Financial Reporting Advisory Group (EFRAG) and the European Commission are coordinating with various global projects, see https://www.efrag.org/News/Project-480/EFRAG-meets-with-international-sustainability-reporting-standard-setters-and-other-related-initiatives, accessed 08.09.2021.
[95] *Platform on Sustainable Finance*, "Draft Report by Subgroup 4: Social Taxonomy", 2021, p. 5.

EU's competences but lie with the Member States, only allowing some broader coordination on the EU level.[96] The same holds true for governance aspects, as disclosure on board diversity regarding ethnicity for example, can even be against national law.[97] Another important consideration is the burden any further reporting places on the companies and financial market participants which would fall under the scope of such a Taxonomy. This holds especially true as reporting on social criteria is not as established yet as those for environmental criteria. [98]
The current environmental Taxonomy already ensures a minimum safeguard of social and governance aspects through its Article 18. A similar approach could be followed by an additional social Taxonomy, thereby defining a DNSH for social activities. A full social and governance Taxonomy would certainly be useful to clarify any ESG labelled financial products and to direct more capital towards socially sustainable businesses, yet given the limit of measurable criteria and data, it seems more feasible to mainly link the S&G to existing standards rather than to create an entirely new set of criteria.

In any case, clarification is needed, as the current framework leaves a gap for all sustainable investment products which cover more than just environmental criteria.

3. *Extending the Taxonomy's scale*

Many of the above-mentioned data-related challenges can be addressed by extending the scale of the Taxonomy Regulation to include all economic activities, thereby significantly widening its scope of application and avoiding that green finance becomes a costly niche product.

The current structure of the Taxonomy Regulation only allows for an activity to be compliant or non-compliant but does not differentiate on the level of environmental sustainability. The two criteria in that regard are the threshold of "significant contribution" that the activity has to meet on the one side, while it cannot fall below the "no significant harm" criterion on the other side.

This shows that the Taxonomy Regulation does already provide a scale with two indicators in order to categorize an economic activity. As mentioned above, for the environmental objective of climate change mitigation, the significant contribution criterion can for example be met when the production of energy leads to less than 100g CO2e/kWh and the significant harm criterion is met once the production leads to more than 270g CO2e/kWh.[99] Other criteria might be more nuanced depending on the different objectives and activities, but generally it is still possible to draw up a clear threshold.[100] The Taxonomy Regulation therefore already provides a scale for each objective, from harming, over a neutral or undefined intermediate category, towards a

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[96] *Platform on Sustainable Finance*, "Draft Report by Subgroup 4: Social Taxonomy", 2021, p. 16.
[97] *Platform on Sustainable Finance*, "Draft Report by Subgroup 4: Social Taxonomy", 2021, p. 46.
[98] *Platform on Sustainable Finance*, "Draft Report by Subgroup 4: Social Taxonomy", 2021, p. 17.
[99] *European Commission*, "Delegated Regulation of 4.6.2021 – Annex II", p. 103f.
[100] *European Commission*, "Delegated Regulation of 4.6.2021 – Annex I and II."

positive contribution. Instead of just using these thresholds to qualify or disqualify each activity, the scale could be utilized to provide a more nuanced Taxonomy Regulation overall.[101] Rather than only allowing for an activity to be compliant and therefore "green" or not, the scope could be broadened to also include "yellow" activities that fall between the two thresholds as well as "red" activities, that significantly harm the objective.[102]

There are many arguments to be raised for such an extension of the Taxonomy. Given that the technical screening criteria will already provide these thresholds, it would require only little adaptions and alterations to extend the scope of the Taxonomy. The implications that would follow are however very significant. From an industry perspective, adding another step or threshold on the bar can give incentives to move an activity from "red" to "yellow", when "green" would be too far out of reach. As for now, companies that realistically cannot comply with the Taxonomy Regulation have no incentives to even slightly improve their environmental performance. On the contrary, it could be demotivating for companies in the hypothetical "yellow" zone of activities to currently be treated identically by the Taxonomy Regulation as those that very significantly harm the environment. It is necessary for the Taxonomy Regulation's thresholds to be ambitious in order to incentivize companies to aim higher and to reach the EU environmental targets. However, the smaller the field of "green" activities becomes, the larger the pool of undefined "other" activities gets. This does not only disincentivize companies but can lead to confusion or misleading investment products.

Companies that hope to fall under the "green" category have a large incentive to gather the necessary data, as under the current framework. It should be noted that the Taxonomy Regulation already includes more activities as "green" through the notion of enabling and transitioning activities than originally envisaged, so companies are already provided with an additional steppingstone in order to incentivize such a transition. Companies that realistically cannot reach those targets could only disclose against the no significant harm threshold. As these thresholds are aimed to base on existing EU laws, the burden to prove compliance is likely to be relatively low. The same would apply for activities which are not related to any environmental objective at all. As soon as they can prove not to significantly harm, they would fall in the "yellow" category by default.

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[101] This idea has been explored at several stages of the legislative process and by several actors involved. The European Parliament for example introduced amendments referring to a "degree of sustainability" (*European Parliament,* "Legislative Resolution for the Taxonomy Regulation", 28 March 2019) which the TEG addressed in its final report (*TEG*, "Final report March 2020", p. 51f.). While the idea was not included in the final text, it is part of the review clause, Article 26(2) Taxonomy Regulation. One of the subgroups of the Platform has explored this option further and published a report: *Platform on Sustainable Finance,* "Public Consultation Report on Taxonomy extension options linked to environmental objectives", 2021. See also *Lorenzo Esposito/Giuseppe Mastromatteo/Andrea Molocchi* (2020): "Extending 'environment-risk weighted assets': EU taxonomy and banking supervision", Journal of Sustainable Finance & Investment, 2020, p. 8.

[102] Environmental scales often use the terminology of different shades of green and brown. A "green", "yellow" or "red" terminology however, similar to energy or nutrition labels, appears to be more precise in terminology, as different shades of green can easily be misinterpreted.

By the nature of their activity, some companies will always harm the environment and some of that harm is inevitable. Categorizing them as "red" is not supposed to slander or punish such companies or activities. In the context of sustainable finance, however, it must be acceptable to categorize activities as unsustainable and advise against investing in them if the aim of the investment is to support environmental causes. A too cautious approach that tries to cater to everyone's interests not only diminishes the effects of sustainable finance but can even reverse them. The aim of the Taxonomy Regulation should not be to simply categorize the "good" and the "bad", but rather facilitate the change from an environmentally unfavourable to a favourable economic activity. Given that the large majority of companies cannot comply with the Taxonomy at the current state, it is crucial to include further elements that can incentivize and facilitate the transition, rather than just leaving them out of the framework altogether.[103] Furthermore, having a "red" or "significant harm" category allows financial market participants and investors to be cautious about the risks associated with these activities.

On the other hand, extending the Taxonomy certainly adds another layer of complexity and may be more burdensome on its users. While caution about "significantly harmful" activities seems advisable, it could also lead to the blacklisting of certain companies and create the risk of stranded assets due to this legislation.[104]

Another consideration concerns the different varieties the Taxonomy could entail. While this paper argues for three categories (green/significant impact, yellow/intermediate, red/significantly harmful) further "shades of green" could allow for a more precise distinction. Any activity currently neither red nor green ends up in a default yellow category. This group may then include both rather harmful, rather beneficial and also those activities, which simply don't have a large impact on the environment. To mark those as an environmentally neutral, but certainly not harmful activity, another category of "no significant impact" could be established.[105] This category may be useful for risk diversification and to allow that enough funding reaches those sectors. It does however add yet another layer of complexity and potential for confusion, as investors then have to determine whether a "neutral" activity is more or less suited than an intermediate one with strong transition potential towards green. Though it would enhance transparency for investors, the added benefit does not seem to outweigh the usability concerns in this case. The same conclusion can be drawn for an additional "always significantly harmful" category, which would include such assets that cannot realistically transition out of being significantly harmful.[106] This may include energy generation out of solid fossil fuels

[103] *Platform on Sustainable Finance,* "Transition Finance Report March 2021".
[104] *Platform on Sustainable Finance,* "Public Consultation Report on Taxonomy extension options linked to environmental objectives", 2021, p.10.
[105] *Platform on Sustainable Finance,* "Public Consultation Report on Taxonomy extension options linked to environmental objectives", 2021, p.34f.
[106] *Platform on Sustainable Finance,* "Public Consultation Report on Taxonomy extension options linked to environmental objectives", 2021, p.24f.

(which is already explicitly excluded from the Taxonomy) and other, similar activities and sectors. While such a distinction could prevent further investments towards activities which have no ecological future, determining this explicitly seems to be an unnecessary burden without many benefits, while at the same time opening the door to a very difficult debate about which activities to include there on the basis of hypothetical assumptions about the activities potential future. Given the possible legal and political pitfalls and the rather limited benefits, this additional category of "always significantly harmful" should not be included in an extended Taxonomy.

The simpler extension to three categories however would lead to more transparency and thereby mitigate the risk of greenwashing complex financial products. At the same time it encourages the transition from a sustainably harmful towards a sustainability beneficial economy, which is ultimately one of the main goals of sustainable finance.

D. Conclusion

By agreeing on a unified approach and the extensive framework the Taxonomy Regulation provides, the EU has taken a necessary step towards its goal of reorienting capital flows towards sustainable investments. Only an EU-wide standardization can sufficiently support the cross-border capital market, strengthen investors' trust in sustainable investment products across the Union and ensure that the legislative targets are in compliance with the emissions and sustainability goals the EU has set. By providing a definition for environmentally sustainable activities and environmental objectives, the Taxonomy Regulation acts as a framework to determine activities potentially suitable for an environmentally sustainable investment, which companies can utilize to attract investors. Financial market participants can rely on the Taxonomy Regulation when creating investment products and investors are protected from greenwashing as they can put their trust in a clear science- and evidence-based framework. Further, this legislation will act as a foundation for other regulatory efforts in the area of sustainable finance, therefore providing a common base that can be utilized across the different sectors.

Yet, next to these advantages there are still some concerning downsides. The Taxonomy requires a significant amount of ESG related disclosure from companies and financial market participants in order to function and it will take a few years until all relevant players have adapted and complied with these requirements. Next to those already covered by the various disclosure requirements, legislators should keep an eye on the other actors in the investment chain, such as ESG rating agencies and SME's.

In order to reach true clarity and comparability on what a sustainable or ESG investment entails and to prevent investors being misled in that regard, it is necessary to provide definitions and thresholds not only for environmental, but also social and governance aspects of sustainability.

Furthermore, the Taxonomy Regulation could miss its goals of preventing greenwashing and facilitating the transition to an overall green economy if it is not applied to the extent the legislators hope for. If only a small percentage of companies and financial market participants utilize it for a highly regulated, but very small green product market, the overall goal to re-allocate billions of Euros will likely not be met. While the use of the Taxonomy Regulation is mandatory when offering green financial products, the availability and cost of gathering the necessary data may discourage companies and financial market participants to offer such products. To mitigate this potential effect, the Taxonomy Regulation should get extended, to include a "yellow" and "red" category, making its use mandatory for almost everyone.

In light of the ambitious environmental targets the EU has set, and which will likely keep on increasing, it is crucial to make sustainable finance mainstream in order to meet the necessary investment targets.

EUSFiL

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