September 6th, 2021

Consultation Response to the Draft Report on Taxonomy Extension Options linked to Environmental Objectives

Additional Considerations

Key Points

The EBF welcomes the opportunity to comment on the draft report of the EU Platform on Sustainable Finance, concerning the extension of the Taxonomy framework.We very much commend the work that the Platform has been undertaking to conceptualize the extension of the taxonomy.

The EBF welcomes the introduction dynamic approach, taking into account the transition efforts of emitting companies. Indeed, taking into account these decarbonization trajectories is a sine qua non condition for achieving the objectives of the European Green Deal, by encouraging the whole economy to start its transition, while ensuring that the transition would be socially inclusive.

We also recognize the complexity and sensitivity of the exercise: unlike the Taxonomy for the classification of environmentally-sustainable economic activities ("green taxonomy"), which has an incentive-creating role in directing capital flows towards said activities, the qualification of an activity in the proposed "permanent significantly harmful" taxonomy/red zone would imply the end of financing of said activities, or their financing at higher costs. In short, it is the whole EU economy and its social stability that is at stake as:

- The time lag between the activities being identified as "permanent red" and the effective "closing" of these activities is difficult to control/estimate.
- It is possible that a decommissioned activity may still meet an important need (e.g. contribution to positive social impact or mitigation of social risk, or be part in a strategic value chain for the EU and its Member States).
- The risk of stranded asset for banks will be significantly accelerated – this could significantly weaken EU banks and their ability to finance the transition of the EU economy.

With this in mind, the EBF makes a number of comments and recommendations regarding the report:

I. Clarification would be helpful as to whether all DNSH would be considered to define the red category or only those on climate objectives.

We understand that the Platform would recommend defining the red category by using the DNSH criteria. It would be helpful to understand if the approach would be (i) multidimensional approach: i.e. an activity would be in the red category if it does not comply with at least one **of the DNSH** (i.e. circular economy, pollution, etc.), or (ii) unidimensional approach (i.e. only climate DNSH would be considered). Our second comment, below, would be particularly relevant if the approach would be multidimensional.

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II. The creation of an SH category, based on the current DNSH criteria of the green taxonomy, should be subject to a prior and thorough quantitative impact assessment and be raised to Level 1.

While there are estimates of the portion of the EU economy and EU banks that are aligned with the green taxonomy, there is currently no effective assessment of the portion of economic activity that does not comply with the DNSH (lack of data in this area, particularly on the circular economy, etc.). For example, the JRC report on the EU taxonomy did not systematically consider the DNSH. There are also strong requirements for "adaptation" DNSH which could involve heavy investment in short time.

In other words, the level of economic activities that would be affected by this category is not known and it cannot be excluded that it would be significant, in particular if the approach is multidimensional (i.e.: red: all activities that do not comply to at least one of the DNSH, whether on climate or on other objective). Furthermore, as the DNSH are based on EU standards, there is a high risk that all non-EU activities would count as red activities.

However, this category (red because not complying with the DNSH but potentially fixing this) and associated reporting will be perceived by the market in the same way as the other categories of the red taxonomy (the one that will always stay red).

The resulting risk would be to underestimate the level of activities concerned, to accelerate too quickly and to too great an extent the closing of these economic activities, and thus give rise to a "disorderly" transition. However, controlling the risk of social and strategic disruption is essential for the continuity of ecological transition measures and the achievement of environmental objectives.

Consequently, this implies to evaluate the approximative proportion of economic activity concerned before issuing any guidance or implementing a mandatory reporting on those activities. Depending on the conclusions of this analysis, putting the discussion at a political level (at level 1) would be critical. It would also allow the EU authorities to anticipate and assess the immediate need for public support.

Finally, an impact analysis, should also take into account the effects of tightened screening criteria in a future-oriented manner.

The transition risks would increase due to the fact that not only the C02 intensity is to be reduced along a transition path, but also that one of the DNSH criteria of all other environmental sustainability goals may be violated. This could then mean that an economic activity classified as "green" that serves climate change mitigation and/or adaption (first DA from April 2021) would suddenly have to be classified as SH or "red" due to the tightening of only one technical DNSH criteria with regard to one of the other ecological sustainability goals. Taking into account all cross references between the SC and DNSH and all six environmental goals - the system developed at the moment is of high complexity of the criteria to be fulfilled.

III. The conceptualization of the various categories of activity is useful, but we recommend to avoid multiplication of labelling and associated reporting.

The idea that there are detrimental activities that can be improved and others that cannot seems essential to introduce. In the same way, the idea of taking into account the efforts of a company to move a detrimental activity towards the intermediate or "green" categories is important. Indeed, it would have the pedagogical virtue of providing a standard approach for analyzing the company's activities. However, we do not believe that it is necessary, or desirable, for all of these categories to be reported against.

The introduction of detailed categories and associated reporting would thus represent an unnecessary operational complexity, with the risk that the reports would ultimately be difficult to read:

- Activities with the potential to improve environmental performance (either by fixing DSNH issue and/or by fulfill the TSC) would in fact be all activities not defined in the list of "always harmful" activities. Please note that this is without prejudice to our position concerning the opportunity of defining these activities as all those that do not comply with the DNSH (see paragraph 1).

- Intermediate activities are all those that would not be green or red.

IV. We support a framework that focuses on the setting up of specific list of the always harmful activities and on taking into account the transition of activities (fixing of DSNH issue and/or significant contribution to EU objectives, in a time consistent with EU objectives).

In order to accompany clients in their transition, an inclusive and positive approach is the only way to find the real balance between all the issues mentioned by the Platform, and recalled in paragraph 1, while also ensuring social cohesion.

In that context, a label would only make sense when it represents a meaningful improvement step in the right direction. It must not focus on the colour (vertical shade of yellow) but on the horizontal movement.

In this regard we are supporting the prioritization of the following classification and reporting:

- Green activities aligned with the taxonomy and the DNSH (taking into account the CaPex to achieve the SC);

- Red activities that cannot fix the DNSH issues.

Hence the distinction between the various level of activities performances in the yellow zone should give rise to further analyze.

For examples the following options could be analysed:

(i) A reporting based on whether the entity has a robust transition plan and makes real effort:

This approach would encourage all companies to engage in the transition and would make it possible to differentiate, for example, between (i) a company in the yellow zone that remains static and (ii) one that keeps improving its performance to eventually reach the green category.

a. For non-financial companies, this would mean publishing information on their transition plans: The prerequisite would be the prior determination of what is a robust and valid transition plan: this could include the level of validation of the plan, the dynamic of transition in the past and the setting of targets in line with a relevant sectoral scenario of 1.5° (perhaps to be recognized by the EU), the audit of the plan, or even the exclusion of certain activities that are always harmful.

b. For financial institutions, it would mean setting up an indicator on the level of financing/investment allocated to companies with robust and valid transition plans .

(ii) A specific reporting on compliance with the DNSH criteria (without being necessarily classified in red zone)

to demonstrate that improvements in the environmental performance are happening

(iii) The establishment of an intermediate transition ratio, based on the CapEx spent by companies to comply with the DNSH threshold or the SC criteria)

Analysis

I. On useful classifications of different environmental performance levels

The need of "substantial contribution" category is obvious and does not raise any particular concern (i.e. aligned with the "green taxonomy" objectives to incentivize activities to environmentally-sustainable activities, for disclosure purposes, etc.).

- A "permanently red" category that should be enriched beyond Article 19(3) of the environmental taxonomy regulation.

The main requirement for structuring these categories should be simplicity, in order to ensure a clear understanding of the framework proposed, as well as any associated reporting, while maintaining the requirement for a dynamic approach.

(i) With regard to an intermediate category: the most important point will be to know which activities are effectively improving their performance

While it is important, this category will be the residual one - between green and red. We are not convinced that developing this category further should be a priority, while it could be an additional and unnecessary burden to report on this. The yellow zone would be all the activities that have the ability to improve their performance. Hence the most important information would be to know which of those activities are effectively improving their performance.

(ii) With regard to "SH activities that could improve their performance"

The EBF agrees it is an important concept. However, the need to prioritize the work of the Platform on developing this category seems likely uncertain to us considering the following elements:

Bank clients may be in multiple activities and it is normally clear which ones they can improve. This is very geographically and contextually dependent. It is complex and expensive for banks to report multiple subclassifications of SH activities.

The qualification of this SH category as covering activities that not comply with the DNSH criteria needs to be subject an impact assessment, in order to assess the proportion of activities currently involved.

Banks also need a taxonomy for transition advisory and financing the transition. To this purpose, it is crucial that the corporate has effectively put in place an effort to improve its performance. In this context, **the** most important is to have guidance for the on what would be a valid transition plans in line with EU climates targets, because investment decisions are long term and financing instruments may have long maturities. An extended taxonomy should allow for forward looking strategies when assessing clients' on a more holistic way, such as portfolio alignment. This implies defining or recognizing an official underlying transition path against which, a company's transition strategy can be assessed.

From Sustainability Linked Loan/Bond origination, we learned that knowing whether an improvement is <u>ambitious (the development of the threshold/the KPI in time</u>) is the most difficult issue to verify. Guidance on vertical intermediate performance levels or transition steps has less priority, the horizontal time dimension is more important: dynamic, forward looking. Banks need verification that the company is "on" or "off" the right trajectory/curve, **but do not need the shade of green/yellow.**

(iii) With regard to the 'No Significant Impact' Category

The NSI category is only relevant provided its creation is intended to be **taken into consideration for the purpose of the Green Asset Ratio**. As such, activities classified as NSI should be **excluded from the denominator**, as they can never qualify to be included in the numerator. As a result, the Green Asset Ratio will be a more faithful and meaningful representation of what is actionable by the companies in terms of sustainability. It will also prevent wrong incentives to improve the GAR by purely reducing the denominator by disinvesting in NSI activities. To make sure that full transparency to external stakeholders is kept, the amount of exposure classified as NSI can be required to be disclosed (either in absolute or relative terms). A **practical approach** to this NSI category should be taken, without over complicated or burdensome thresholds. A simple **list of 'colorless activities'**, could be fit for purpose, including for instance health, education, etc. It is important that the definition of the NSI category is available **well in advance of the first publication of the Green Asset Ratio**, so that the companies can incorporate the definition in the GAR computation process. Finally, labelling usually triggers a debate about the right label/colour for the current performance of the activity (<u>status quo</u>). We suggest to design the extended taxonomy in a way that reflects <u>change</u> in performance, i.e.in accordance to the transition investment plans of companies.

II. Recognising transition activities and "significant harm" performance level

Guidance on permanently SH activities and SC thresholds are most important, set against a long-term trajectory. Beyond the "substantial contribution" activities and permanently SH activities, what is the most important is to know whether the corporate has effectively engaged in the right pathway considering the relevant sector. This implies an EU framework to identify/set up minimum criteria relating to the scenario that could be used by corporates as the trajectory of the corporates will be assessed against those scenarios (for instance, 1.5°scenario with a robust governance, etc.) As previously explained, bank clients may be involved in multiple activities and it is normally unclear which ones they can improve, which is geographically and contextually dependent. It is too complex to use sub-classifications of SH activities. We are supportive of an approach which prioritized a red category limited to "permanently SH" activities, with no possibility of improvement. We do not consider that the other categories of SH activities need to be defined in detail at this stage. Considering current DNSH as criteria to qualify SH activities is an approach that should be subject to an impact assessment, as proposed document attached. In any case, we would be in favor of a quantitative assessment before introducing any guidance on the qualification of SH category of activities non-compliant with the current DNSH.

III. Advantages of a "significantly harmful" taxonomy

From the perspective of EBF, the most important advantages are:

- Avoidance of a binary perception that could result from the GAR, that would help the market and stakeholders to understand that not all activities excluded from the GAR are significantly harmful.

- It would also give important insight on the forthcoming pillar 3 disclosures, on which EBA is working on, to identify which activities and sectors to focus on.

However, for client transition advisory and financing it is most important to have guidance on the consistent trajectories of activities, because investment decisions are long term and financing instruments may have long maturities. Sharing transition plans, including investments, for specific sectors will be extremely helpful. Guidance on vertical intermediate performance levels has less priority, the horizontal time dimension is more important. Banks need verification that the company is "on" or "off" the right trajectory/curve, but do not need to know the shade of green/yellow.

In that context the development of real transition framework is critical, with two levels of reporting on transition:

- At level of the corporates. This implies reporting on transition plans at the level of the corporates.

- At the level of banks, it could result in a Transition Ratio on Total assets (dynamic, forward looking) showing the level of asset directed toward corporates that are doing real efforts to transition towards the 2050 target, with intermediaries points of time in line with EU targets (please refer to point 3 of the executive summary).
Lastly, on the operational side, SH will often also be at the level of products and not at the level of an activity, e.g. in case of harmful substances. It would therefore be helpful to use the deeper level of the NACE codes for more precise classification (in EU: Prodcom and CN/HS codes) of the activity for which the SH criteria are applicable. In the end, this would result in a blacklist of SH products.

IV. Disadvantages of a “significantly harmful” taxonomy

The classification should be simple; the ‘green’ classification is very complex and we need to avoid this for the harmful taxonomy.

An extended taxonomy should be designed in a way that supports the transition of entire sectors and does not hinder their access to finance their transition.

We are in the early stage of the green taxonomy development, so it is important first to focus on the implementation and practical application of the existing taxonomy as well as the other environmental objectives before defining a broader taxonomy. The EU should now focus on making the current taxonomy more usable, increase operationality and reduce complexity.

Hence, it should be evaluated in what extent it would be productive for the EU to press ahead unilaterally with a large approach of the red taxonomy; and what the impact would be on the competitiveness of European businesses vis-à-vis the jurisdictions without a similar Taxonomy in force”.

Finally, for the reasons above and in order to manage or harming strategic activities for EU, it is essential to assess, prior to any guidance, the level of activities that would be concerned by an approach of SH taxonomy based on DNSH (see introduction).

Starting with a limited list of activities which could not improve their performance appears to be a more balanced solution.

V. Significantly harmful activities and those than can transition

While it is important for the market to differentiate between activities capable of improvement, we should avoid multiplication of labelling and focus on effective transition effort. Furthermore, the creation of a category of SH category based on the current DNSH criteria should in our view in any case be subject to a prior and thorough quantitative impact assessment and be raised to Level 1.

The risk would be to underestimate the level of activities concerned and to accelerate too quickly and to too great an extent the decommissioning of these economic activities, and thus give rise to a "disorderly" transition. However, controlling the risk of social and strategic disruption is essential for the continuity of ecological transition measures and the achievement of environmental objectives.

Consequently, this implies to evaluate the approximate proportion of economic activity concerned before issued any guidance or implementing a mandatory reporting on those activities. Depending on the conclusions of this analysis, putting the discussion at a political level (at level 1) would be critical. It would also allow the EU authorities to anticipate and assess the immediate need for public support.We believe that the Platform and the European Commission should first develop the red category and only then to assess further guidance on mandatory reporting requirements.

VI. Recognition of the intermediate performance level

The recognition of such a category is important. However, the number of labels /reporting in the market should be limited as much as possible. There is no need for a label if that label could be used for financing entire companies that are neither "green" nor "always harmful". This label would only make sense when this label represents a meaningful improvement step in the right direction. It must not focus on the colour (vertical shade of yellow) but on the horizontal movement. KPI linked instruments are an example of such labels (the step up/down mechanism that we see in the market is not an essential part of the name). The EU Green Bond Standard allows for an investment to become green a transition period of 5 years that can be extended with another 5 years, which may already provide a dynamic blueprint for how an intermediate category may be approached.Investments by companies steering away from Significant Harm (decommissioning/exit costs) and other meaningful improvements could be labeled as a "transition" category.

VII. Recognition of "intermediate turnover"

Labelling all turnover as "intermediate" does not add any value and will only make it more difficult to finance the transition. A label only makes sense when this label represents a material and well defined improvement step in the right direction. Labelling usually triggers a debate about the right label/colour for the current performance of the activity (status quo). We suggest to design the extended taxonomy in a way that reflects change in performance, i.e. transition investment plans of companies. We are most interested in a change from yellow to green or red to yellow or red to green, or vice versa; changes within the yellow band are also very important as they contribute to the decrease of the CO2 emissions. We assume that the green/yellow/red asset ratios will remain constant for many banks, especially if the EU taxonomy thresholds become more stringent. What matters is whether they constantly invest in improvements. These changes must be assessed by transition plans defined and monitored at corporate level, and validated by recognized third party auditors. Labeling must therefore reflect changes in associated investments (CaPex or Opex).

VIII. Recognition of valid transition plans

The dynamic approach is critical to really consider the transition: if only the activities that pass the DNSH test currently are in the intermediate transition category, it would mean that corporate effort to comply with the DNSH criteria would not be take into account.
However, we consider that the transition should not only consider at level of the activity but should be also encouraging at level of corporate business model. Guidance on vertical intermediate performance levels or transition steps has less priority, the horizontal time dimension is more important: dynamic, forward looking. Banks need verification that the company is on or off the right trajectory/curve. We need to use science-based criteria to project transition.

This implies defining an official transition path against which a company's transition strategy can be assessed . This should be defined at sector level and by geography by a recognized (public) authority, and be aligned with each country's Nationally Determined Contribution (as monitored by the OECD) and national climate laws. The company's transition strategy should be regularly reviewed and adjusted by a recognized third party auditor that would follow a standard methodology defined by public authorities. Finance is essential for those sectors to be able to undertake the necessary transition and the extended taxonomy should not result in establishing penalising factors relating to the financing of such transitioning activities. It should also be taken into consideration that the taxonomy was not defined for banks' risk management purposes. An extended taxonomy should allow forward looking strategies when assessing clients' on a more holistic way such as portfolio alignment. This implies defining an official transition path against which a company's transition strategy can be assessed. THE ICMA transition guidance handbook provides an example of useful disclosures.

IX. Suggestions for extending the taxonomy framework for significantly harmful activities, intermediate performance, intermediate transition

The different levels of transition efforts could be envisaged through the following options :

(i) The implementation of global transition indicators: The approach at the level of a company's business model makes it possible to encourage all companies to engage in the transition and would make it possible to differentiate, for example, between (i) a company in the yellow zone that remains static and (ii) one that is making real efforts. For companies, this would mean publishing information on their transition plans. For financial institutions, it would mean setting up an indicator on the level of financing/investment allocated to companies with robust and valid transition plans (the transition aligned ratio).

The prerequisite would be the prior determination of what is a robust and valid transition plan: this could include the level of validation of the plan, the dynamic of transition in the past and the setting of targets in line with a relevant sectoral scenario of 1.5° (perhaps to be recognized by the EU), the audit of the plan, or even the exclusion of certain activities that are always harmful.

(ii) the reporting on non compliance with the DNSH criteria (without necessarily include them in the red zone reporting)

(iii) establishment of an intermediate transition ratio that would allow a company to include the CaPex in order to comply with DNSH test or the SC criteria this would address the concern to distinguish the different starting points of activities.

X. Advantages of a "no significant impact" taxonomy

The NSI category is only relevant provided its creation is intended to be **taken into consideration for the purpose of the Green Asset Ratio**. As such, activities classified as NSI should be **excluded from the denominator**, as they can never qualify to be included in the numerator. As a result, the Green Asset Ratio will be a more faithful and meaningful representation of what is actionable by the companies in terms of sustainability. It will also prevent wrong incentives to improve the GAR by purely reducing the denominator by disinvesting in NSI activities. To make sure that full transparency to external stakeholders is kept, the amount of exposure classified as NSI can be required to be disclosed (either in absolute or relative terms).

A **practical approach** to this NSI category should be taken, without over complicated or burdensome thresholds. A simple **list of 'colorless activities'** could be fit for purpose, including for instance health, education, etc. It is important that the definition of the NSI category is available **well in advance of the first publication of the Green Asset Ratio**, so that the companies can incorporate the definition in the GAR computation process.

XI. Disadvantages of a "no significant impact" taxonomy

It may add complexity and imply burdensome reporting obligations. Subject to our previous response, we also prefer the idea of expanding the current taxonomy to include more green activities (e.g. those related to "low-impact" companies).

XII. Activities that could be considered NSI

Some sectors that are classified as service activities in NACE (such as many information and communication companies, public sector, administrative activities, education/crèches, health/social work, lawyers, financial advisors, arts, etc.). Back-of-envelope calculation indicates that 25% value-added and 35% of companies in the EU would potentially fall into this bracket – depending on the definition of SC/SH. This bracket would cover 90% plus of SMEs or micro-enterprises. So there is no need to add extra work to SMEs and micro-enterprise to map their NSI activities, as classification in NSI does not bring anything to them. SMEs, while not all sectors, may be included and the scope should be aligned with the CSRD. All cultural activities, service to individuals (such as bakeries), etc. Participation in environmental labelling or certification schemes would add complexity to an already-existing multitude of labels.

XIII. Further guidance for NSI activities

A **practical approach** to this NSI category should be taken, without over complicated or burdensome thresholds. A simple **list of 'colorless activities'** could be fit for purpose, including for instance health, education, etc.

XIV. A phased approach to the NSI category and the recognition of "green"service providers

The NSI category is only relevant provided its creation is intended to be **taken into consideration for the purpose of the Green Asset Ratio.** It is important that the definition of the NSI category is available **well in advance of the first publication of the Green Asset Ratio**, so that the companies can incorporate the definition in the GAR computation process.