Recommendations for reviewing the EU Taxonomy for UK application

Introduction

The IRSG welcomes the UK government's announcement that it intends to implement a green taxonomy based upon the scientific metrics of the EU taxonomy, as well as the establishment of a UK Green Technical Advisory Group to review the metrics and ensure they are aligned with the UK market.

The EU Taxonomy provides the most comprehensive framework developed to date to identify economic activities, sectors and companies that are contributing to meeting the Paris Agreement's goals and advancing environmental sustainability more generally. While recognising some of the limitations of the EU's approach, a significant amount of thought and work has gone into developing and designing the Taxonomy by the EU's former Technical Expert Group and currently the Platform on sustainable finance. We therefore strongly agree with the approach that the UK Government has set out for the UK to stay aligned to the principles of the EU taxonomy in the short-term and to review the requirements as it moves towards reinforcing its existing advantages in the field of Sustainable Finance. We would also like to urge the UK government to accelerate progress on this with a view to providing significant clarity to UK issuers and financial market participants in advance of COP26 in November.

Such an approach would provide certainty for international firms operating in the UK and the EU, avoid the need to comply with differing sustainable finance regulations, and enable the comparison of sustainable economic activities across Europe according to common, science-based criteria. In addition, the vast majority of the existing EU regulations to which the current draft Technical Screening Criteria refer will form part of EU retained law in the UK. Initially adopting the EU Taxonomy should minimise the compliance burden on UK firms, while maximising the pool of investors they can attract, helping to position UK PLC at the forefront of the green transition.

In this paper, the IRSG has considered the purpose and usability of the EU Taxonomy as well as practical challenges when implementing a version of the EU Taxonomy that reflects the needs and specificities of the UK economy. A guiding principle underpinning the development of the UK's approach to the Taxonomy should be that criteria are science-based, coupled with pragmatism to ensure that climate science can be translated into a pragmatic and actionable framework for companies of all sizes to be able to engage with.

As the implementation of the Taxonomy will be a long-term project, the IRSG sees the opportunity for the UK to develop the framework over time and will produce a second paper as a follow up looking at the medium-term challenges of how to deal with some of the limitations of the EU Taxonomy, such as the limited concept of transition, the heavy and complex compliance burden, the narrow eligibility and lack of international applicability.

1. Purpose and usability

a. The Taxonomy is a classification system that provides investors, companies and policymakers with a harmonised and uniform approach to identifying sustainable economic activities as well as activities that, while not yet fully sustainable, nevertheless contribute to the transition towards a sustainable economy.

b. While the Taxonomy can be useful for multiple purposes, in the EU it has two main objectives. First, the Taxonomy is the EU's official reference and common measurement tool against which the market will benchmark green financial products. Second, the Taxonomy will provide clarity to the market, and gives end investors the ability to make informed decisions regarding sustainable investments and sustainable operating practices. By defining which economic activities can be deemed sustainable and under which circumstances, the Taxonomy alleviates the fear of greenwashing and so facilitates more effective capital allocation decisions.

c. The EU Taxonomy will also give clear guidance for participants in a given sector on what it takes to substantially contribute to climate change mitigation and adaptation, the first two of its six objectives, and how to attract investment to support their transition to cleaner and more environmentally robust operating practices.

d. HMT should consider that the UK Taxonomy needs to support and not conflict with cross border activities. There is also interest in UK companies continuing to attract EU investment from sustainable or green funding sources, which may require them to publish their alignment with the EU Taxonomy, and therefore co-ordination between the UK and the EU will maximise the flow of capital. Developing a form of mutual recognition of Taxonomies, with the EU and other jurisdictions as Taxonomies are adopted, will be crucial for the success of a UK Taxonomy and facilitating cross-border flows of capital to economically sustainable activities.

e. In order to successfully deploy the UK Taxonomy, we recommend that the Technical Advisory Group consists of a usability workstream. The usability workstream can support HMT in:

   - Assessments of data quality, availability, and market preparedness for any proposed disclosure obligations;
   - The role of sustainability accounting and reporting standards in supporting the application of the technical screening criteria;
   - The usability of the technical screening criteria for different stakeholders, including developing best practice guidance in applying the Taxonomy.

2. Setting the criteria

a. We broadly support the EU's approach to reference existing frameworks (such as using GHG protocol for emissions) as this is likely to result in less work for companies and investors who will already be familiar with and complying with such rules. Many of these regulations will have been onshored into UK law but, given the significant cross-over, it will be important to consider how any changes in UK law impacts the Taxonomy. One such example is the thresholds for some of the manufacturing sectors, that are derived from the EU ETS. Going forward, the UK will have its own version of the ETS and its own ETS benchmark which may be set at a different rate to the EU rate. HMG announced in December that the benchmarks used to calculate free allocation entitlement in the UK will be the same as Phase IV of the EU ETS and therefore we might not expect any divergence in the first instance, but this could develop over time.

b. Notwithstanding the first point, references to EU/UK law can make it harder for international companies to verify their compliance with the Taxonomy criteria, which may impact the attractiveness of London as an international finance centre for equity listing or green bond listings. While the EU system contains detailed requirements for alternatives to be vetted and approved by the EU's Platform for sustainable finance, a more principles-based approach, setting out guidance on how companies can disclose where they are using proxies that can be considered equivalent to the Taxonomy could be helpful to reduce bottlenecks. The Monetary Authority of Singapore (MAS) has recently published its proposal for a Green Taxonomy for Singapore and ASEAN which includes some mapping of available industry standards. This could be used as a proxy as an example of useful guidance that the Technical Advisory Group could produce.

3. Data and reporting

a. While the UK has not onshored the reporting parts of the Taxonomy, its ultimate viability as a tool will depend on access to robust and detailed data for investors whilst ensuring that obligations on UK companies are proportionate. The current lack of reliable data represents a major impediment to integrating the Taxonomy into company's investment decision making in a more systematic way. We believe that the following four issues will be critical for investors to embrace the Taxonomy:

- A defined methodology for companies to calculate their turnover, CapEx and Opex to ensure reliability, comparability and, ultimately, auditability of the data;
- Sufficient granularity of the information reported to align with investor preferences and needs;
- Considering the restrictiveness of the 'use of proceeds' only approach, expanding inclusion to potential entity level alignment and a broader consideration of how Taxonomy designation interacts with funding sources such as equity, operating capital financing and long term 'patient capital', to reduce the limitations of the current approach;
- Encouraging firms to report not only on those activities that are fully aligned to the Taxonomy but also activities that are potentially aligned and any forward-looking targets to so that investors can understand the direction of travel;
- Reporting not only on the numbers but also the more qualitative elements, including the companies' due diligence policies with regards to Do No Significant Harm and minimum social safeguards.

b. The Taxonomy, however, should not be seen in isolation but as one of the components that should form part of a wider reporting framework, such as the TCFD, in order to enable companies to provide a broader picture regarding their approach to climate change and environmental risk management, including relating to governance, strategy, risk management and metrics and targets. We welcome the acknowledgement by BEIS in the 'Consultation on requiring mandatory climate-related financial disclosures…' that Government will continue to align work between the Taxonomy and mandatory TCFD reporting and will seek to align obligations where possible.

c. The reporting framework should also seek to leverage existing frameworks and requirements, such as the UK Modern Slavery Act disclosures, to reduce the need for companies to reinvent the wheel in order to comply with the Taxonomy. A key consideration is how to leverage existing sources of information and reporting to meet these criteria, to minimise unnecessary compliance costs and accelerate take-up of Taxonomy alignment designation by eligible counterparties and projects.

4. Implementation and phasing-in

a. As with any new framework, the industry will need time to implement and adapt to the requirements of the Taxonomy. The Advisory Group could be useful in speeding up this process by developing a roadmap (as was done in relation to TCFD reporting) and best practice guidance for different sectors as to how to implement and report against the Taxonomy, as well as to address the inevitable data gaps that are likely to apply in the early stages of implementation.

b. One of the major issues financial services institutions in the UK are having is that the implementation date of the EU Taxonomy is the same for companies and funds financial and non-financial firms but, whereas companies have to report eligibility from January during 2022 (for the accounting period 2021), and alignment a year after (from Jan 2023, for the accounting period 2022). Based on the current proposal, Funds have to have updated their prospectuses by 2022, which means that at least for the first reports, investment firms will not have any data from companies and will have to rely on estimates. Addressing this timing mismatch is one of the recommendations of the European Banking Federation in its report setting out high level recommendations to legislators and regulators[1]. Companies within the scope of the Non-Financial Reporting Directive, to be replaced by the now called Corporate Sustainability Reporting Directive, (which will include a number of banks) are not due to publish the more detailed taxonomy data, which funds may require for their disclosure purposes, until 2023. This could be addressed through guidance on how to address data gaps.

c. A key area that will need to be addressed is how to apply the Taxonomy to legacy assets, where evidencing compliance with the Taxonomy requirements will be most challenging. For example, some of the "do no significant harm" criteria are process-based, e.g. having done a climate adaption assessment or consulted with stakeholders on water management. These requirements are largely drawn from the practices applicable in the space of project finance, based on the expectation that companies are raising finance before the project starts rather than looking to apply the rules retroactively to existing assets. Some pragmatic guidance about how firms can "grandfather" some existing assets where some of this documentation is not available might be useful.

Conclusion

We would urge the UK Government to move quickly towards providing certainty to the market in relation to how it will seek to implement the Taxonomy in the UK, preferably well in advance of COP26. HMG should set out a clear roadmap of how it envisages the UK Taxonomy applying to companies and financial intermediaries in the UK, with the potential for a phased implementation that could be tied in to the rolling out of mandatory TCFD reporting.

We stand ready to work collaboratively with the Green Technical Advisory Group which the Green Finance Institute will co-chair. A key role of the Advisory Group will be, in the first instance, to assess the technical screening criteria to ensure they are relevant to the UK, which we believe are likely to at least in the short-term. We would therefore urge HM Treasury to ensure that the group also has a short-term focus on helping the market apply and implement the Taxonomy through the establishment of a Usability and Implementation workstream who can produce practical guidance to help speed up adoption in the marketplace.

As international discussions get underway around global approaches to Taxonomies and sustainable finance – including in relation to the social dimension, on which we are also working- we see merits in the UK having a strong voice in this debate, shaping the future direction of both the Taxonomy in the UK and globally towards a greater focus on supporting the transition to a low carbon world, which we will explore in more detail in a subsequent paper.

The International Regulatory Strategy Group (IRSG) is a practitioner-led body comprising leading UK-based representatives from the financial and professional services industry. It is an advisory body both to the City of London Corporation, and to TheCityUK. The IRSG taxonomy subgroup includes representatives from financial services firms, trade associations, the legal profession and data providers.

[1] Testing the application of the EU Taxonomy to core banking products: high level recommendations - January 2021, report by the European Banking Federation