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CAPITAL ADVISORS

ESG NEWSLETTER

SETTING RULES OF THE ROAD FOR SUSTAINABLE MARKETS

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By now, it is difficult to overstate the strength of sustainable business and investing trends. Yet, for all the force behind the trend, it seems fair to say that bringing consistency and clarity to definitions and metrics for disparate sustainability initiatives around the world is still developing.

With that in mind, it is noteworthy when one of the more substantial efforts to standardize important aspects of sustainable operations takes a major step forward. That is exactly what the European Union (EU) Commission's Technical Expert Group (TEG) on Sustainable Finance did at the end of 2019.

In December, it introduced the EU Taxonomy, a classification system for defining economic activities that can be called environmentally sustainable. The TEG not only introduced the taxonomy, but it got ambassadors from the EU's 28 member states to endorse it and it is on track for approval by the EU Parliament and Council in early 2020.[1]

For those focused on understanding sustainability and tracking the growth of the trend, the taxonomy takes a number of important steps. In the context of economic activity, the taxonomy addresses six environmental initiatives: 1) climate change mitigation, 2) climate change adaptation, 3) sustainable use and protection of water and marine resources, 4) pollution prevention and control, 5) transition to a circular economy—an economic system aimed at eliminating waste and the continual use of resources and 6) protection of healthy ecosystems.

The taxonomy sets standards to determine whether an economic activity is environmentally sustainable. These standards apply whether the project is undertaken by a business or offered as an investment to individuals and institutions. Every EU-listed company with more than 500 employees will be required to disclose revenue and capital spending on the six environmental objectives covered by the taxonomy. The standards also provide guidance to improve corporate disclosure of climate-related information.

In addition, asset managers, banks, financial exchanges, insurers and non-governmental organizations are required to apply the taxonomy's standards for green financial assets, including public finance instruments and development banks or corporate bonds presented as environmentally sustainable. By doing so, financial services providers will speak a common language to use for investment activities.

For example, the taxonomy includes standards for methodologies EU climate benchmarks employ and the disclosures they use in reporting on them. The regulation also defines investments including green, environmental, social and governance (ESG) and mainstream products. As it develops further over the next two years, the taxonomy targets enabling an EU eco-label for financial products.

Let's take a practical example. When making an investment decision about a gas-fired power plant, the taxonomy's detailed criteria is a guide to the level of emissions that is environmentally acceptable for the activity. That knowledge can inform disclosures for an investment offering for issuers and security research for investors. Standardization can help issuers and investors speak clearly, concisely and honestly with one another about environmental performance.

The High-Level Expert Group (HLEG) for Sustainable Finance recommended the idea of this taxonomy in 2017. The EU Commission included the HLEG recommendation in its action plan for financing sustainable growth. The TEG's job is to design and implement the taxonomy for the EU Commission.

To be sure, the TEG effort is not the only organization pursuing standardization in sustainable business and investment approaches. The EU is coordinating its work with the UN Principles for Responsible Investment (UNPRI), the UN Environmental Programme (UNEP) and The Task Force on Climate-related Financial Disclosures (TCFD) among others. We participate in many of these initiatives and will cover similar efforts undertaken by other groups in the U.S. and globally in future issues of Breckinridge's *ESG Newsletter*.

Similar to the efforts of the Sustainability Accounting Standards Board (SASB) to standardize and improve accounting and reporting on ESG performance of business and industry, the EU's sustainable finance work should bring greater insight and transparency to the sustainable performance of business and investments.

For individual and institutional investors, the standards can provide comparability among investments to support security analysis and the validation of a security's sustainability characteristics while avoiding instances of *greenwashing*: conveying a false impression or providing misleading information about the environmental performance of a company or product.

From a security research perspective, the consistency of approach promoted by the taxonomy will benefit the work of analysts and investors who consider sustainable financing initiatives. The work of the EU and others is advancing the discipline of sustainable business operations and investment approaches, while serving as a template for extension of sound sustainability finance practices globally.

Readers can access a helpful user's guide for the taxonomy *here*.

FOOTNOTES:
1. "Global ESG Outlook 2020," Bloomberg Intelligence, 1/13/2020.