PERSPECTIVES

An Investor's Perspective on the Proposed Taxonomy for Sustainable Finance

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Can stakeholders (regulators, policymakers and market participants) deliver a sustainable finance framework that serves the end-client well? The European Union's technical expert group has just published its final recommendations on the taxonomy for sustainable finance, establishing common criteria to classify environmentally sustainable activities that support the transition to a low-carbon economy. Fresh from discussing the topic at the Responsible Investor Europe Conference in London, Julie Moret, Head of ESG at Franklin Templeton, offers some immediate feedback on the usability and implications for investors

The need to build a workable framework for sustainable investment remains a priority for governments, regulators and investors.

But the wide range of constituents, all with varying priorities and directions, makes achieving commonality a real challenge.

At last, there seems to be consensus that the investment industry's contribution to the sustainable finance agenda should move its focus away from ethical and values-based exclusions and negative screening, towards a more holistic understanding about environmental, social and governance (ESG) issues.

When it comes to consideration of climate change mitigation in particular, we're seeing a shift of focus towards investment opportunities and investors' role in financing the transition to a lower- carbon environment.

However, there remain some concerns about the effective application of a standardised taxonomy. These concerns may hinder the pace at which businesses and investors adopt the taxonomy and could stall the progress made on mainstreaming ESG integration.

Who's Driving the Agenda?

Much of the impetus for driving forward the sustainability agenda comes from governments.

Nearly 200 countries have committed to Nationally Determined Contributions (NDCs), which embody their efforts to reduce national emissions and adapt to the impacts of climate change.

In Europe, we're seeing the result of translating these commitments into hardwiring sustainability into capital markets to help finance the shift to a low-carbon economy.

Taxonomy and Definitional Standards

The European Union (EU) is working to finalise its Action Plan on Sustainable Finance, designed to engage the financial sector in its fight against climate change. The plan has three objectives:

- Reorienting capital flows towards sustainable investment.
- Mainstreaming sustainability into risk management.
- Fostering transparency and long-termism.

Its first action is the creation of what it calls an “EU sustainable taxonomy”. In other words: consistent and workable definitions and classifications of whether an economic activity is considered environmentally sustainable.

The EU’s technical expert group (TEG) has just published its final recommendations on the taxonomy. We recognise that developing a taxonomy is a complex exercise and applaud the work of the TEG.

While we’re looking through the proposals and assessing our feedback, we’ve identified six areas which we believe will determine how practical and workable the taxonomy will be from an investor’s perspective.

1. **Disclosures.** Investors may simply not have access to the appropriate data to assess if a company’s activities meet sustainability criteria. At Franklin Templeton, we strongly support the efforts to set standards for the disclosure of decision-useful information that is material, measurable, comparable and forward-looking. We recognise active investment managers have a role to play in engaging with issuers to narrow the disclosure gap. As such, we are strong supporters of efforts from the Sustainability Accounting Standards Board (SASB). We believe these efforts contribute to the improvement of corporate disclosure on sustainability metrics, on which the wide scale adoption of the taxonomy is reliant.
2. **Narrow Definition of the Taxonomy.** The implementation of the taxonomy uses a staggered approach, focusing in the first stage on using just an environmental lens to define sustainable activities. But we fear this could have unintended consequences by narrowing the focus on integration efforts to environmental considerations only and ignoring social and governance considerations. In our experience, investors recognise that ESG issues are often interlinked as they assess the value of an issuer. The originally drafted taxonomy categorised environmentally sustainable activities under two headings: activities that are already low carbon (i.e. zero-emissions transport) and those that are enablers for low carbon (e.g. manufacturers of wind turbines). In our view, these categorisations don’t give sufficient credit to companies demonstrating progress on transitioning their operational business models and meeting targets to progress to a low-carbon economy. We would advocate for the inclusion of transitional activities in the taxonomy.
3. **Greater Clarity on Defining Adverse Impacts.** The taxonomy sets out guidelines for identifying environmentally sustainable activities. However, we believe investors would benefit from greater clarity around the criteria, metrics and thresholds. In particular, the guidelines say activities must meet the action plan’s criteria for climate change mitigation and climate adaption, but also that they should “do no significant harm” to the plan’s other objectives. Those objectives are: sustainable use and protection of water and marine resources; transition to a circular economy, waste prevention and recycling; pollution prevention and control; and protection of healthy ecosystems. However, there is not yet detailed criteria for each objective, making it difficult to assess the “do no significant harm”, particularly in the full product lifecycle and supply chain.
4. **Thresholds and Implications for International Portfolios.** Although we recognise the TEG is making recommendations for the EU’s Action Plan, we feel it should reflect the global nature of the environmental objectives in scope. For example, the TEG has recommended a set of metrics to consider when assessing an activity’s climate change mitigation and adaptation eligibility. However, it uses thresholds set within a European context. For the taxonomy to be workable for international portfolios, we would advocate the TEG to expand the taxonomy guidelines to wider geographic areas. We believe this could also greatly influence the global adoption of the taxonomy.
5. **Agreeing User-friendly Sector Classifications**. The TEG has adopted the Statistical Classification of Economic Activities in the European Community (NACE) industrial sector classification system. This system is used and recognised by European agencies and national governments, but in our experience, it’s not a system most investors are familiar with. We feel it would be important to translate the NACE classifications to systems more commonly understood by investors such as The Global Industry Classification Standard (GICS), Sustainable Industry Classification System (SICS) and Industry Classification Benchmark (ICB).
6. **Dynamic and Flexible.** Recognising there is rapid technological advancement in a fast-evolving field such

as climate adaptation, it is important for the taxonomy to be practical and pragmatic. We feel the framework needs to be flexible enough to allow the taxonomy to adapt in a timely manner to reflect technological and scientific innovation, which could alter its parameters.

A Positive Move, but Prepare for Teething Problems

We see the EU Sustainable Action Plan as a pivotal development that's moving to hardwire sustainability into the undertakings of financial institutions and businesses.

As it potentially impacts the activities of all constituents of the investment chain, including banks, insurers and asset managers, we think it's vital that everyone pays attention to it.

Generally speaking, we see the move towards the action plan as a positive development. It has significant implications for both businesses and investors in gathering, disclosing and assessing the information, which will likely require system upgrades for reporting. As with any policy undertaking that transforms into regulation, the industry needs to accept a period of adjustment that will likely result in teething problems.

We firmly believe that even though there may be initial shortcomings in the framing and implementation of the action plan, we, as an industry, shouldn't use that as an excuse not to engage fully.

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