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EU SUSTAINABLE FINANCE ACTION PLAN
THE NEW TEG REPORTS AND EU COMMISSION GUIDELINES

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The recently published Technical Expert Group on Sustainable Finance (**TEG**) reports and EU Commission Guidelines elaborate the next phase in the implementation of the EU's Sustainable Finance Action Plan.

On 18 June 2019 TEG published its final technical guidance on climate change adaptation and mitigation under the taxonomy proposals, its final report on an EU Green Bond Standard and its interim report on sustainable benchmarks and the EU Commission also published its final guidelines to supplement companies' understanding on how to apply the Non-Financial Reporting Directive to climate related disclosures.

TEG: TAXONOMY TECHNICAL REPORT

The EU Commission's proposal for the taxonomy regulation was published in May 2018 and its aim is to provide a framework to determine whether an activity can be classed as sustainable. Such classification can be used in different areas such as sustainability labels, standards and benchmarks. The taxonomy regulation identifies six environmental objectives and an activity must significantly contribute to one of these in order to be environmentally sustainable. An activity must also 'do no significant harm' (**DNSH**) to any environmental objective and comply with minimum social safeguards. The regulation is still subject to political agreement.

The proposed regulation mandated the TEG to provide technical advice on the six specified environmental objectives and develop related technical screening criteria. This report covers two of the environmental objectives; climate change mitigation and climate change adaptation. It identifies a list of 67 activities which can make a substantial contribution to climate change mitigation and sets out the DNSH requirements for each activity. It also sets out a framework and general principles for assessing economic activities that could satisfy the climate change adaptation objective and provides worked examples of nine activities.

The exact scope of the taxonomy regulation is not yet finalised but in broad terms it will apply to those financial market participants who market a product as being sustainable or having sustainable characteristics. These market participants will be required to back up their sustainability claims based on the taxonomy criteria and real data. These obligations are intended to address greenwashing and related reputational risks. It is expected however that the taxonomy will have broader

"The EU Taxonomy is … a framework: a list of economic activities assessed and classified based on their contribution to EU sustainability related policy objectives."

TEG Taxonomy Technical Report

applications, and perhaps drive improved investor discussion, better expression of investor preferences and an increase in sustainable financial products such as green bonds and loans.

Approach

The regulation required the TEG to develop minimum standards, set qualitative and quantitative thresholds, use existing EU methodologies and classifications where possible and base the criteria on scientific practices. The TEG also applied its own principles which included ensuring the criteria were flexible, easy to use and supportive of transition activities. It has aimed to translate the Paris Agreement targets and UN Sustainable Development Goals for markets and financial participants in a user-helpful way to enable them to assist in the necessary mobilisation of private capital towards a low carbon and climate resistant economy.

Climate change mitigation – what's included

Article 6 of the taxonomy regulation states:

"*An economic activity shall be considered to contribute substantially to climate change mitigation where that activity substantially contributes to the stabilization of greenhouse gas concentrations in the atmosphere at a level which prevents dangerous anthropogenic interference with the climate system by avoiding or reducing greenhouse gas emissions or enhancing greenhouse gas removals…..*"

The TEG used emission levels and known mitigation opportunities to prioritise which climate change mitigation activities to include in the report. It identified and developed detailed criteria for 67 activities drawn from a list of seven broad sectors.

The screening criteria for climate change mitigation activities are science based and often establish minimum thresholds for determining an activity as sustainable. In many cases these are set on the basis of levels of GHG emissions for the activity with a set profile that gets more ambitious over time. For example, criteria for electricity generation set a threshold of 100g CO2 equivalent/kWh (declining to 0g CO2 equivalent/kWh by 2050).

Climate change adaptation – what's included

Article 7 of the taxonomy regulation states:

"*An economic activity shall be considered to contribute substantially to climate change adaptation where that activity contributes substantially to reducing the negative effects of the current and expected future climate or preventing an increase or shifting of negative effects of climate change …..*"

There is an inherent difference in approach between climate change mitigation and adaptation because all sectors needs to adapt to become more climate resilient. The TEG recognises that adaptation activities are context and location specific, so activities will not be subject to hard threshold minimum standards, unlike the climate change mitigation criteria. The report proposes a generic approach to sector and activity identification and sets out guiding principles and qualitative screening criteria.

The TEG identified two concepts to consider the types of activity that could comply with the climate change adaptation objective:

- where the environmental performance of the activity can be improved and able to perform well following changes in climate; and
- where the activity improves environmental performance of other activities.

The guiding principles to be used to assess activities are:

- The economic activity reduces all material physical climate risks to the extent possible and on a best effort basis;
- The economic activity does not adversely affect adaptation efforts by others; and
- The economic activity has adaptation-related outcomes that can be defined and measured using adequate indicators.

The report uses the concepts and principles to provide worked assessments of nine activities; (1) growing of non-perennial crops; (2) silviculture and other foresting activities; (3) production of electricity by hydropower; (4) transmission lines; (5) sewerage; (6) provision of telecommunications for weather monitoring; (7) non-life insurance; (8) research and development dedicated to climate change adaptation and (9) engineering and technical consultancy dedicated to climate change adaptation.

The nine assessed activities were selected on the basis they are among the most vulnerable to the negative effects of climate change in Europe and they represent a large share of gross value added and employment in Europe.

Transition

The TEG is explicit that its recommendations are intended to support the transition from brown to green focusing on activities rather than entities. A higher carbon emitting entity can use the taxonomy and criteria to identify which part of that entity's activities comply with the environmental objectives. The report also states that partial steps to meeting criteria should be "encouraged". The TEG has stressed that the taxonomy is a comparative disclosure tool to assist market participants and not an instruction to investors to only invest in certain companies. Notwithstanding this approach, certain activities have been excluded from the list of activities, such as nuclear power and construction of buildings for fossil fuel activities.

The report makes it clear that for activities that are currently transitioning to low carbon options the specified criteria in the report is intended to be short-term and is expected to become more stringent over time.

Do no significant harm (DNSH)

For an activity to comply with the broad principle of being 'environmentally sustainable' under the taxonomy proposal it must not only contribute substantially to one or more of the environmental objectives and comply with the technical screening criteria but must 'do no significant harm' to any other environmental objective. DNSH criteria are set broadly using a baseline of compliance with EU environmental laws so the majority of the criteria should already be being met.

A DNSH assessment is included in the technical screening criteria for each identified climate change mitigation activity. A less detailed and more generic qualitative DNSH criteria for activities relating to climate change adaptation is proposed in the report but the TEG identifies development of more detailed criteria as one of its next steps.

Next steps

The TEG has issued a further call for feedback on its proposals and will issue a further report to the Commission in December 2019. The TEG reports are designed to inform the Commission's adoption of delegated acts to support the taxonomy regulation and will need to be formally adopted. However, it is open to companies to begin to use, or at least consider, the taxonomy and the criteria specified in the report before this happens.

The report states that TEG will continue to support the Commission and continue its work on development of the taxonomy until end of 2019. It is anticipated that a new entity, the Platform on Sustainable Finance, will be established and continue the work of the TEG.

TEG: EU GREEN BOND STANDARD

The TEG published its interim report on a "Proposal for an EU Green Bond Standard" in March 2019 and little has changed in the final report.

By way of background, the outline of a new standard was suggested in the reports of the EU High-Level Expert Group of Sustainable Finance published in July and December 2018 and forms part of a wider push by the Commission to create harmonised standards and labels for "green" financial products with the aim of protecting integrity and trust in sustainable financial markets.

The EU Green Bond Standard (GBS)

The Basics

To qualify as an "EU green bond", the proceeds of the issue, or an amount equal to such proceeds, shall be allocated only to finance or refinance "green projects" defined as (a) contributing substantially at least one of the EU's "environmental objectives" (which are based on the current principles of the Taxonomy Regulation) while (b) not significantly harming any of the other objectives and (c) complying with the minimum social safeguards represented by the principles and rights set out in the eight fundamental conventions identified in the International Labour Organisation's declaration on Fundamental Rights and Principles at Work.

In addition, an issuer of an EU green bond is required to produce a Green Bond Framework (**GBF**) which confirms the alignment with the GBS and provides details on all the key aspects of the proposed use of proceeds and on its green bond strategy and processes.

In addition, issuers are required to report annually until full allocation of proceeds. The final allocation report is required to be externally reviewed. Issuers are also required to produce an impact report at least once during the lifetime of a bond after full allocation of proceeds and thereafter in case of material changes in allocation.

A standardised format for reporting has been proposed by the TEG with the aim of further harmonising disclosures.

Points to note

Much like the ICMA Green Bond Principles (the **ICMA GBP**), the proposed GBS is a "use of proceeds" based standard and much of the architecture of ICMA GBP is embedded in the proposed GBS.

There are however a few key points to note:

- use of proceeds must comply with the EU's stated environmental objectives and, when it is in force, the Taxonomy Regulation. This is a much more prescriptive standard than the ICMA GBP. The technical guidance accompanying the Taxonomy Regulation includes specific metrics, criteria and guidelines as to what may be funded by an EU green bond. This will need consideration by Issuers and their advisers when drawing up their green bond frameworks;
- external reviewers will need to be accredited by an independent body (the TEG suggests that this role could be fulfilled by ESMA). The ICMA GBP has no such accreditation obligations. The accreditation and standardisation of external reviewers may be helpful in mitigating concerns around greenwashing if a robust process can be put in effect;
- it is hoped that by providing a standardised format for EU green bonds it will be easier for EU regulators to (a) monitor with confidence the flow of finance into green assets; and (b) develop incentives to encourage the growth of the green bond market. The TEG report notes that these could include schemes to offset the costs of issuing green bonds, preferential purchasing of EU green bonds by central banks, tax incentives and preferential prudential treatment of EU green bonds; and
- the development of the Taxonomy Regulation needs to be taken into account. The current draft of the Taxonomy Regulation requires that financial products such as bonds that are marketed within the European Union as environmentally sustainable will need to comply with the definitions of environmentally sustainable activities as set out in that Regulation. Whilst the GBS is billed as voluntary, if that requirement is included in the final text of the Taxonomy Regulation in the Official Journal, it is difficult to envisage a scenario where the EU GBS would not be used for green bonds offered into the European Union.

The TEG envisages potential use of the GBS for tax incentives and preferential prudential treatment.

TEG: INTERIM REPORT ON EU CLIMATE TRANSITION AND EU PARIS-ALIGNED BENCHMARKS AND BENCHMARKS' ESG DISCLOSURES

Political agreement on the text of the amendments to the Benchmark Regulation was reached in February 2019 and the TEG was mandated to give the Commission advice on the ESG disclosure requirements for all benchmarks and minimum standards for Carbon Transition Benchmarks (CTB) and Paris-Aligned Benchmarks (PAB). TEG will deliver its final report in September 2019.

ESG disclosures

The amendments to the Benchmark Regulation provide that all benchmarks, except those relating to interest rates and currencies, will need to make ESG disclosures. The index administrator needs to include the methodology it adopts in relation to ESG factors and an explanation in its benchmark statement of how ESG factors are reflected in the benchmark. The interim report aims to standardise these disclosures by providing minimum content requirements for methodology and specifications, including where the benchmarks are CTBs or PABs, and template documents.

This new disclosure requirement is intended to increase transparency, awareness and comparability of ESG factors in benchmarks, lead to better and more informed benchmark selection by investors and ultimately encourage companies to improve their ESG disclosures in order to achieve benchmark inclusion.

Requirements for CTBs and PABs

The TEG's mandate included a specific remit to develop recommendations in relation to CTBs and PABs to prevent the risk of greenwashing. Greenwashing in this context being "the misalignment with the stated investment objective of pursuing ambitious climate goals".

The minimum standards for CTBs and PABs relate to the following areas (included here in abbreviated form):

1. **Input Data:** GHG emissions data should relate to the GHG protocol or ISO standards and should be consistent and transparent;
2. **Carbon intensity:** a specific carbon intensity calculation is recommended and a CTB should have a 30% reduction in carbon intensity compared to investable universe and a PAB should have a 50% reduction;
3. **Inclusion of scope 3[1] emissions data:** these should be considered on a stepped timeline with consideration first being given to the energy and mining sectors (when regulation is effective), to transport, buildings, materials and industrial sectors (within two years) and all sectors (within four years);

Carbon Transition Benchmark: "the underlying assets are selected, weighted or excluded in such a manner that the resulting benchmark portfolio is on a decarbonisation trajectory….."

Paris Aligned Benchmark: "the underlying assets are selected in such a manner that the resulting benchmark portfolio's GHG emissions are aligned with the long-term global warming target of the Paris Climate Agreement….."

1 Scope 3 emissions are indirect emissions that derive from an entity's broader supply chains

4. **Decarbonisation trajectory:** CTB and PAB administrators should use the IPCC decarbonisation trajectory for alignment with the Paris Agreement;
5. **Green share/brown share:** to the extent this is disclosed a CTB should have a green share/brown share ratio at least equivalent to the ratio in the investable universe and a PAB should have a green share/ brown share ratio four times higher than the investable universe;
6. **Disclosures:** certain annual disclosures are required, including to what extent the IPCC decarbonisation trajectory has been achieved; and
7. **Do no harm principle:** companies that are involved in controversial weapons and those found in violation of global norms (such as OECD Guidelines) should be excluded from the benchmark and administrators should also consider excluding exposure to companies that significantly harm any of the EU environmental objectives (as specified in the taxonomy regulation).

EU COMMISSION: GUIDELINES ON REPORTING ON CLIMATE-RELATED INFORMATION ("CLIMATE REPORTING GUIDELINES")

The Climate Reporting Guidelines are intended to supplement, not replace, the Commission's existing 2017 guidance in relation to the Non-Financial Reporting Directive (NFRD). In particular the six general principles of good non-financial reporting set out in the 2017 Guidelines will apply, these being that disclosures should be (1) material; (2) fair; (3) comprehensive but concise; (4) strategic and forward looking; (5) stakeholder orientated and (6) consistent and coherent. As with the 2017 Guidelines, the Climate Reporting Guidelines are non-binding. They also recognise that disclosures will vary between companies depending on activities, geographies and scale of the climate related risks and that methodologies in climate related disclosures are evolving quickly.

The Climate Reporting Guidelines specifically encourage companies to read the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) and incorporate a number of the TCFD recommendations. The Guidelines and the TCFD recommendations are seen as mutually compatible.

The Climate Reporting Guidelines underpin much of the projects and aims outlined in the TEG reports, and the EU Sustainable Finance Action Plan generally, as unless companies improve their climate disclosures in a transparent and consistent manner based on reliable methodologies and data, the usefulness of the taxonomy and other ESG disclosure requirements will be limited.

"Good investment decisions start with good information – that means getting companies to do their climate reporting in a clear and consistent way."

Valdis Dombrovskis

A snapshot of the Climate Reporting Guidelines

Who	The guidelines are intended to be used for companies that fall within the scope of the NFRD, being large listed companies, banks and insurers with more than 500 employees.
When	The disclosures are not mandatory and a company should exercise its own judgement, but disclosures should be considered if they are necessary for an understanding of a company's development, performance, position and impact of its activities.
Where	The default location of disclosures is the company's management report but other locations such as a separate report or the annual financial filings (as recommended by the TFCD) are possible. The climate-related information should be easily accessible for intended users.
What	The guidelines specify a number of climate-related disclosures for each of the five reporting areas under the NFRD: (a) *business model* e.g. how climate-related risks and opportunities impact the company's business model, strategy and financial management. (b) *policies and due diligence* e.g. the company's climate related policies and emissions targets and board oversight and management role in assessing climate related risks and opportunities. (c) *outcome of policies* e.g. outcomes of company's policy on climate change, including climate related risk indicators and targets, and development of GHG emissions against targets. (d) *principal risks and risk management* e.g. the process of identification and management of climate related risks over different time horizons. (e) *key performance indicators* should be included if relevant, useful to support other climate-related disclosures and to allow for comparability across companies and jurisdictions. The guidelines include some recommended indicators including those relating to GHG emissions, energy consumption and physical risks.

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Clifford Chance has a large global team of experts that cover a breadth of sustainability issues including those relating to: environmental regulation; sustainable finance (including green and social bonds, green securitisations and green and social loans); renewable energy; asset and fund managers; and climate risk and litigation.

Please contact one of the authors or your usual Clifford Chance contact to be put in touch with one of our experts.

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