

SFDR: A new regulatory landscape for sustainable investment in Europe

Part 4: Taxonomy



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Marketing communication





To be aligned, or not to be aligned, that is *not* (yet) the question

This paper is the fourth in our series “Stay on Top of SFDR”. It focuses on the European Union environmental taxonomy. After defining what the taxonomy covers and what it aims to achieve, we explain its role in the regulatory context – alongside the CSRD and SFDR – and how it is currently starting to be referenced in SFDR. Finally, we offer some perspective on the next steps, and a few tips to guide investors in their selection of asset management partners that are fit for this regulatory environment.

1. Understanding the EU environmental taxonomy.

What is the EU environmental taxonomy?

The European Union's environmental taxonomy is a classification system that translates the EU's climate and environmental objectives into criteria for economic activities to be considered "environmentally sustainable" or "green".

For an economic activity to be considered "environmentally sustainable", it must:

1. **contribute to at least one of 6 environmental objectives**, which are:

- climate change mitigation
- climate change adaptation
- the sustainable use and protection of water and marine resources
- the transition to a circular economy
- pollution prevention and control
- the protection and restoration of biodiversity and ecosystems

2. **do no significant harm** to any of the other environmental objectives, and

3. **meet minimum safeguards**, notably pertaining to social impacts, such as the United Nations Guiding Principles on Business and Human Rights.

The key indicators for determining whether an economic activity contributes to an environmental objective and for asserting that it does not harm any of the other objectives are the "technical screening criteria" (TSCs). These can take the form of quantitative thresholds (i.e. CO₂ emissions per kWh) or qualitative requirements pertaining to processes and practices used to carry out the economic activity.

The taxonomy was developed with the contribution of the Technical Expert Group ("TEG") on Sustainable Finance, with the aim of defining science-based, clear and feasible TSCs grounded in a robust methodology.

The taxonomy recognizes three types of activities with regards to environmental objectives:

- **“direct” activities:** zero or low-carbon emission activities that contribute directly to the fight against climate change or the other objectives set by the taxonomy, such as developing well-insulated energy efficient office buildings;
- **“enabling” activities:** activities that enable other activities to achieve environmental goals, e.g., the production of insulating building materials or the manufacture of low-tension light bulbs;
- **“transitional” activities:** in areas in which there are currently no truly environmentally sustainable solutions yet, transitional activities are those that perform best relative to their peers in terms of criteria set by the taxonomy.

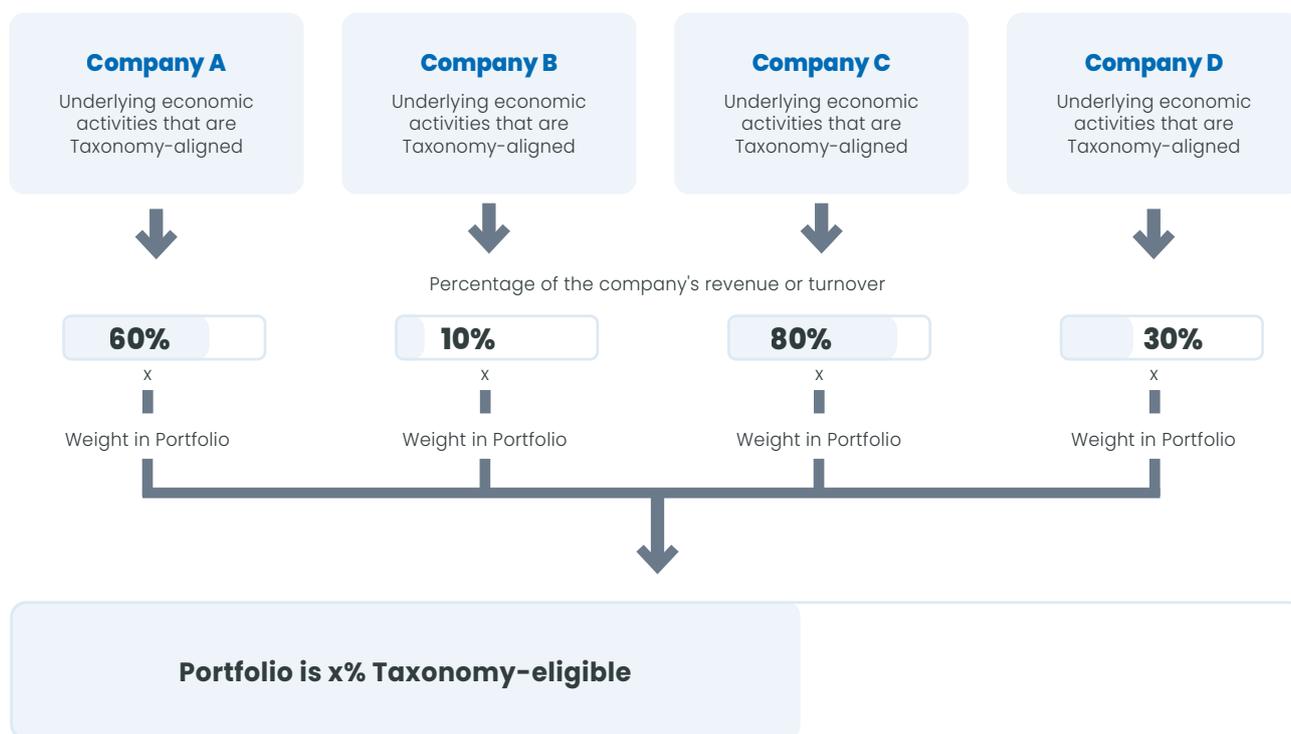
For example, when it comes to the economic activity defined as “construction or operation of solar panel technology to produce electricity”, which is a “direct” activity, the taxonomy sets out the following thresholds with regards to the objective of climate change mitigation:

Screening for climate change mitigation	Thresholds
Photochemical ozone creation potential	<0.05kg C2H2 eq per 1 MWh of electricity
Eutrophication potential	<0.05kg PO43-eq per 1 MWh of electricity
Particulate matter PM10	<0.05kg/per 1MWh of electricity
Fine particulate matter PM2.5	<0.02kg/per 1 MWh of electricity

Source: EUROMOT Position Paper 2017, https://www.euromot.eu/wp-content/uploads/2021/09/EU-Taxonomy_SFP-draft-report-on-4-other-env-objectives_EUROMOT-position_power-sector_FINAL.pdf
 Data provided for illustration purposes. Definitions of the screening criteria are available in Appendix.

For investors, it is important to note that the taxonomy defines environmental sustainability at the level of an economic activity. This means that when looking at investment opportunities through the prism of the taxonomy, it is important to understand the corporate’s underlying activities. Once each of these activities has been classified as taxonomy-aligned or not, the overall taxonomy-alignment of the portfolio can be calculated, as shown in the illustration below.

Figure 1:
Assessing taxonomy-alignment at portfolio level



Source: Candriam based on understanding of the EU taxonomy through the various reports.
For illustrative purposes only

What does it aim to achieve?

Tackling climate-related and other environmental issues is pivotal to a more sustainable economy. The origin of the EU taxonomy is the 2015 Paris Agreement, following which the EU set the objective of climate neutrality (“net zero”) by 2050, as well as three ambitious goals for 2030:

European Union renewable energy targets:

- minimum of 55% cut in greenhouse gas emissions vs 1990 levels
- minimum 45% share of renewables in final energy consumption

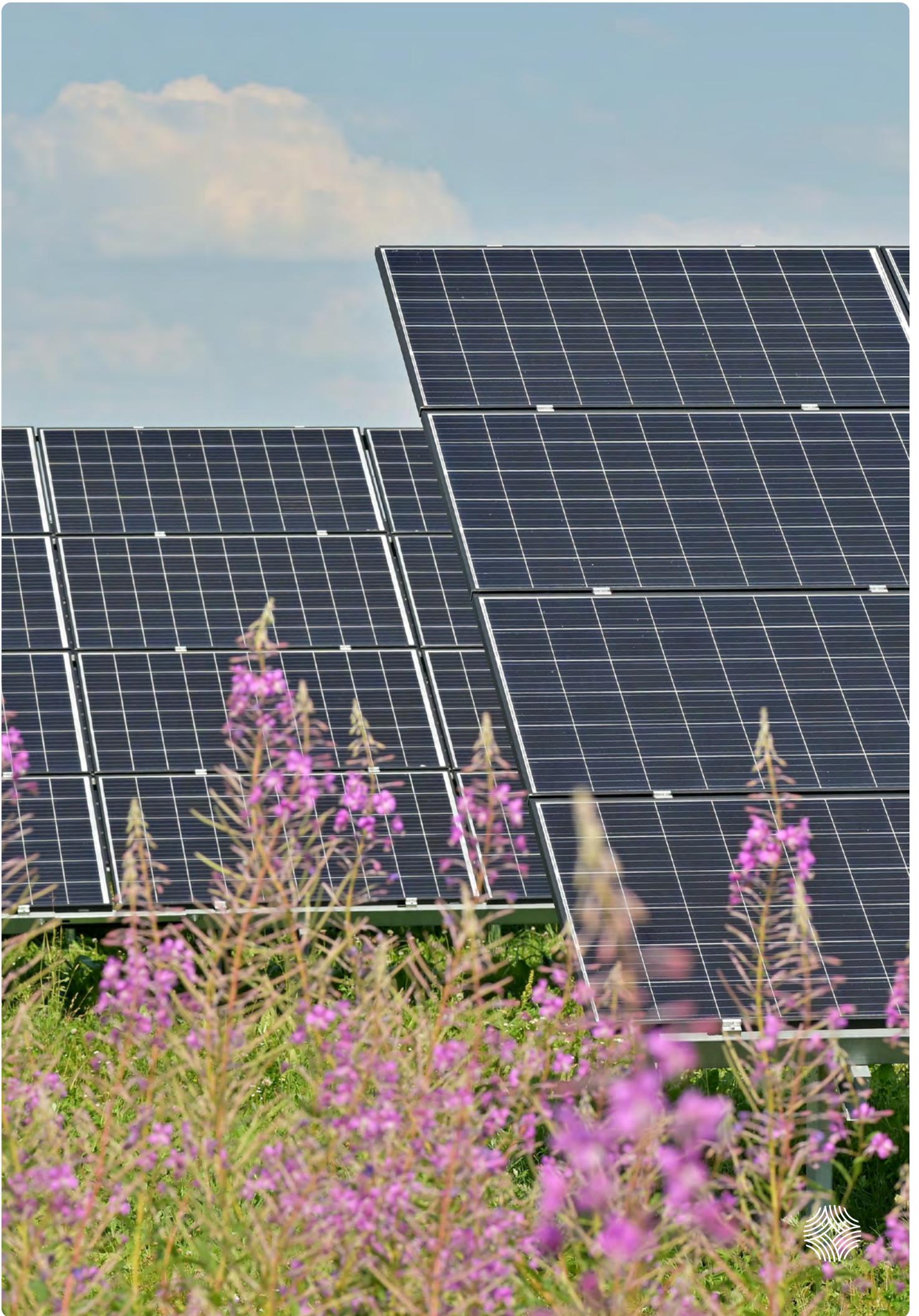
European Union energy efficiency targets:

- minimum 32.5% energy savings versus business-as-usual scenario

To reach these goals, the European Commission (“EC”) developed an Action Plan on Sustainable Finance with the aim of financing a more sustainable future. EUR 1,000 billion should be spent on sustainable investments¹ over the next decade. However, this public money will not be enough to fully finance the transition, and therefore the EU is enacting hard law to encourage private capital to support green projects and a sustainable economy and society in general.

The EU taxonomy has been established in this context and with the dual purpose of re-orienting private capital flows towards more sustainable activities and bringing transparency to investors via a definition of standards used to guide these changes. Thus, the taxonomy’s objective is also to guide investors in their choice of sustainable products, and to prevent greenwashing.

1 - The European Green Deal Investment Plan and JTM explained (europa.eu), https://ec.europa.eu/commission/presscorner/detail/en/qanda_20_24



2. How does it fit in the regulatory context?

The CSRD – Taxonomy – SFDR Tryptic

To ensure that the objectives of the Paris Agreement and the EU Action Plan on Sustainability Finance are met, the taxonomy is working alongside complementary initiatives. Hand in hand, the taxonomy, the Corporate Sustainability Reporting Directive (CSRD) and the Sustainable Finance Disclosure Regulation (“SFDR”) set mandatory requirements for companies and financial market participants:

- **CSRD**, previously known as the Non-Financial Reporting Directive (“NFRD”), **covers the sustainability reporting of companies across sectors in the EU**, requiring them to provide information on their environmental and social impact;
- As explained above, **EU taxonomy** is a classification system that **defines which economic activities can be considered as environmentally sustainable** and under what conditions;
- **SFDR** shelters the **sustainability disclosure requirements of financial market participants**, including sustainability risks and Principal Adverse Impacts (“PAI”) at entity and product level.

It is easy to see how these three regulatory elements work together in theory: CSRD provides sustainability-related data, the taxonomy offers a framework for the interpretation of that data, and SFDR outlines disclosure requirements. In practice, however, we are still in a transition period and, notably due to delays in the implementation of some these elements, the regulatory tryptic is not yet fully functional. This creates some data and implementation issues, which we will discuss in the following sections.



SFDR sets out a comprehensive reporting framework that facilitates the comparison of sustainable investment strategies.

In addition to the tryptic and as part of the EU Action Plan on Sustainable Finance, several other initiatives have been launched:

- the **EU Climate Benchmarks Regulation** encompasses the EU Climate Transition Benchmark (“EU CTB”) and the EU Paris-Aligned Benchmark (“EU PAB”). Both include specific objectives related to greenhouse gas emissions reductions and the transition to a low-carbon economy.
- the **EU Green Bond Standard** (“EU GBS”) has set as its objective to define a standard on how entities can issue green bonds to raise funds to finance large-scale investments whose proceeds are used to finance sustainable activities and projects.
- the **EU Ecolabel**, still a work in progress, aims at certifying that products are aligned with certain environmental sustainability standards.

Implementation through SFDR

As explained in our previous papers, SFDR sets out a comprehensive reporting framework that facilitates the comparison of sustainable investment strategies. It requires markets participants to disclose how they consider and manage sustainable risks and Principal Adverse Impacts (“PAIs”) within their strategies. The point is to help investors choose among various financial products, by asking product providers to disclose different levels of information in relation to the degree of consideration of sustainability. SFDR defines three levels, or categories in this respect:

- **Article 9** products, which **have a sustainable objective**
- **Article 8** products, which **promote ESG characteristics**
- **Article 6** products, which **do not promote ESG characteristics nor have a sustainability objective.**

The taxonomy is closely intertwined with SFDR. Today, SFDR is one of the key means through which the taxonomy is starting to be referenced in investment reporting.

Figure 2:

Disclosures at product level

	Article 6 Products without ESG aspects	Article 8 Products with ESG characteristics	Article 9 Products with ESG objectives
ESG Risks (Article 6)	Manner in which ESG risks are integrated into investment decisions		
Principal Adverse Impacts (Article 7)	Explanation on if & which & how adverse impacts are considered		
Precontractual Disclosures (Article 8 / Article 9) & Periodic Disclosures (Article 11)		How are E and/or S characteristics considered	How are E and/or S objectives achieved
	EU Environmental Taxonomy		
	Predefined 'warning' (Article 7 Taxonomy)	Predefined statement regarding the application of the DNSH principle (Article 6 Taxonomy)	% Taxonomy Alignment to "environmental objective" (Article 5 Taxonomy)

Source: Candriam

A first area of SFDR through which the taxonomy is implemented is the suitability test which, in turn, is effective through the Markets in Financial Instruments Directive (“MiFID”). Details on the sustainability-related suitability test can be found in our [previous paper on SFDR and MiFID](#).

Another level of SFDR at which the taxonomy is referenced is the set of **pre-contractual and periodic disclosure templates** that financial market participants must use to disclose information on products classified as Article 8 and 9:

- two templates covering the pre-contractual disclosure at product level, including any needed taxonomy-related information (one for Article 8 and one for Article 9)
- two periodic reporting disclosure templates at product level (one for Article 8 and one for Article 9)

For example, in the pre-contractual disclosure for Article 9 funds, product providers must confirm that the product has a sustainable investment objective, and disclose the minimum % of sustainable investments with an environmental objective; they can then specify whether these investments are aligned with the EU taxonomy².

These disclosures must be implemented by asset managers from January 2023 onwards.

For a concrete example of how Candriam implements SFDR requirements, please refer to the dedicated page on our website³.

2 - EU Taxonomy Candriam Paper, https://www.candriam.com/en-fr/professional/SysSiteAssets/medias/insights/topics/sri/2020_12_eu_taxonomy_en_web.pdf

3 - Candriam SFDR webpage, <https://www.candriam.com/en-fr/professional/sfdr/>

Template pre-contractual disclosure for the financial products referred to in Article 9, paragraphs 1 to 4a, of Regulation (EU) 2019/2088 and Article 5, first paragraph, of Regulation (EU) 2020/852

Product name: *[complete]*

Legal entity identifier: *[complete]*

Sustainable investment objective

Does this financial product have a sustainable investment objective?

[tick and fill in as relevant, the percentage figure represents the minimum commitment to sustainable investments]

YES

NO

It will make a minimum of **sustainable investments with an environmental objective:** ___%

in economic activities that qualify as environmentally sustainable under the EU Taxonomy

in economic activities that do not qualify as environmentally sustainable under the EU Taxonomy

It will make a minimum of **sustainable investments with a social objective:** ___%

It promotes Environmental/Social (E/S) characteristics and while it does not have as its objective a sustainable investment, it will have a minimum proportion of ___% of sustainable investments

with an environmental objective in economic activities that qualify as environmentally sustainable under the EU Taxonomy

with an environmental objective in economic activities that do not qualify as environmentally sustainable under the EU Taxonomy

with a social objective

It promotes E/S characteristics, but **will not make any sustainable investments**

Taxonomy, CSRD and the data challenge

With regards to application to the taxonomy and the measurement of taxonomy alignment, two things must be kept in mind.

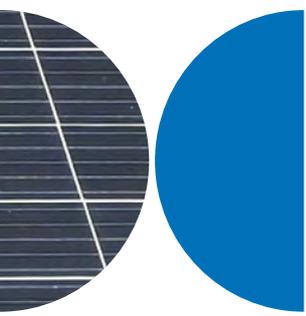
First: Today, only a small portion of our economy is taxonomy-aligned. The taxonomy reflects the world we want to evolve towards, more than the current one. Moreover, it does not yet cover all economic sectors.

As of now, only activities on climate change mitigation and climate change adaptation are applying to the EU taxonomy, as shown in the table below. However, from January 2023 the activities substantially contributing to the remaining four environmental objectives will be considered too.

Please, note that the “D”, “E” and “T” in the following table refer to “Direct”, “Enabling” and “Transition” activities for the underlying environment objective and that to have an in-depth knowledge of activities you can refer to [EU Taxonomy Compass webpage](#).

Sector	Climate Mitigation	Climate Adaptation
Arts, entertainment and recreation	-	E
Construction and real estate	D, E, T	D
Education	-	E
Energy	D, E, T	D
Environmental protection and restoration activities	D	E
Financial and insurance activities	-	E
Forestry	D	E
Human health and social work activities	-	D
Information and communication	E, T	D, E
Manufacturing	D, E, T	D
Professional, scientific and technical activities	E	E
Transport	D, E, T	D
Water supply, sewerage, waste management and remediation	D, E	D

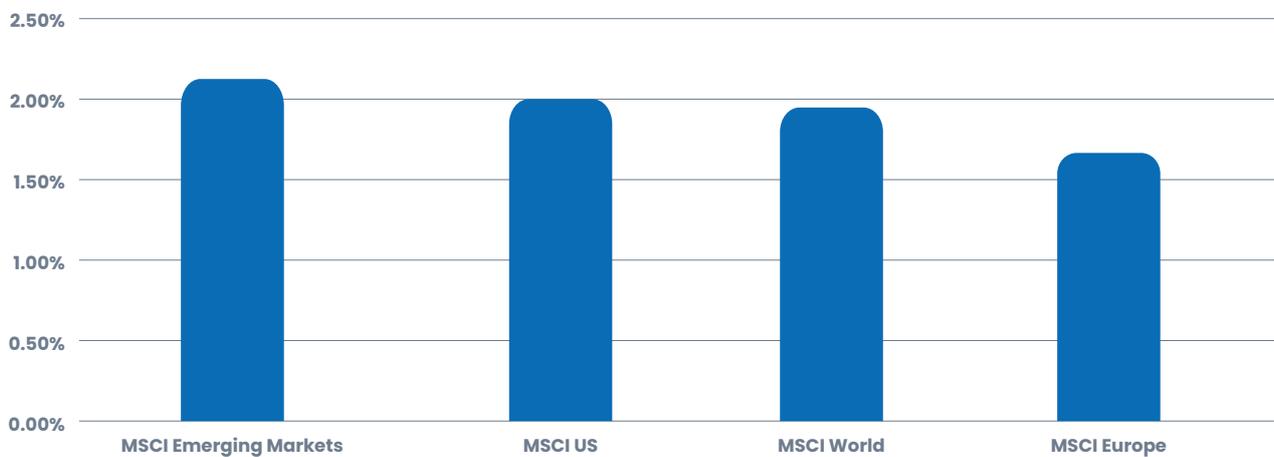
Source: EU Taxonomy Compass webpage, <https://ec.europa.eu/sustainable-finance-taxonomy/taxonomy-compass>



As a result, when looking at major, broad-based stock market indices, taxonomy-alignment is generally below 5% today, across regions.

Figure 3:

Taxonomy-alignment on the main equity indices



Source: Candriam, Data as at 12 December 2022

Second, the EU taxonomy highlights one of the key challenges with regards to sustainable investing: data. It is currently very challenging to measure most companies' alignment to the taxonomy due to the lack of relevant data and corporate reporting standards on extra-financial indicators.

These issues of data quality and availability affect the entire financial industry. The implementation of CSRD in 2024 will undoubtedly bring some relief, at least as far as EU corporates are concerned. CSRD introduces more detailed requirements to report on sustainability issues than its initial version known as the NFRD. Investors can then use this data to assess companies and their underlying economic activities within the framework outlined in the taxonomy.

In the meantime, financial market participants should continue to use their influence, notably through voting and engagement, to push for greater disclosure of non-financial information.

3. What's next?

An evolving framework

The taxonomy is due to evolve and develop over time.

For example, in July 2022, the taxonomy was updated to include gas and nuclear energy as transitional activities under certain circumstances and strict conditions. The inclusion of nuclear, in particular, was subject to some debate. Although the substantial contribution of nuclear energy to climate change mitigation has been recognized, the 'do no significant harm' principle has been challenged by some for this activity, notably regarding the treatment or disposal of nuclear waste. In response, the EC appointed the Joint Research Center ("JRC") to evaluate potential harm to other environmental objectives. JRC's final report⁴ states that its assessment "*did not reveal any science-based evidence that nuclear energy does more harm to human health or to the environment than other electricity production technologies already included in the taxonomy as activities supporting climate change mitigation*".

Such updates indicate that we can expect additional adjustments of the taxonomy in the future, to continue to reflect as much as possible the world's evolution toward a more sustainable future.

Social taxonomy still needs to be developed

Whilst the EU environmental taxonomy already includes requirements on social matters such as human rights and labour conditions, we must recognize that social factors are as important as environmental ones, and that they are a crucial part of the EU's objective to achieve not only a transition, but **a just transition**. Social issues are also pivotal to the achievement of the United Nations' Sustainable Development Goals, as well as the Paris Agreement to reduce social issues such as access to education and healthcare.

The European Platform on Sustainable Finance published, in February 2022, the final report on social taxonomy that will be used as a basis to develop a social taxonomy. Unlike the environmental taxonomy, the social one is not purely science-based but contingent on practices and values.

4 - JRC Publications Repository - Technical assessment of nuclear energy with respect to the 'do no significant harm' criteria of Regulation (EU) 2020/852 ('Taxonomy Regulation') (europa.eu), <https://publications.jrc.ec.europa.eu/repository/handle/JRC125953>

Is your asset management partner fit for this regulatory context?

As we have seen, the EU taxonomy and the measurement of taxonomy-alignment are, to a certain extent, still “work in progress”.

This begs the question: what should investors look out for when selecting asset management partners for their sustainable investments? And which criteria in particular can investors use to check that an asset manager is fit and ready for this regulatory context?

We believe that the following elements are of particular importance:

- The asset manager’s understanding of ESG data, its quality and materiality. To tackle the challenges related to the lack of quality data, an asset manager should conduct its own in-depth data assessment and undertake data quality and relevance checks.
- Proven ESG analytical framework. Fundamental, thorough research to assess the sustainability of invested issuers is at the core of sustainable investing. For corporate issuers, investors should check whether the asset manager analyses each company’s underlying economic activities, as this reflects the spirit of the taxonomy.
- Paris-aligned solutions: For investors who aim to be aligned with the Paris Agreement’s targets, it is important to check if asset managers use forward-looking data on company temperature. This is the basis for measuring portfolio temperature and can be, at this stage, a meaningful alternative to a taxonomy-based approach.
- Dialogue and engagement: Asset managers should demonstrate impactful engagement with issuers, both through dialogue and voting, as these are indicators of a real commitment and forward-looking mindset. It confirms that those asset managers acknowledge their role and take their part as key players in the shift to a sustainable future.



Appendix.

Screening criteria

The Photochemical Ozone Creation Potential (POCP): scale quantifies the relative abilities of volatile organic compounds (VOCs) to produce ground level ozone.

Eutrophication potential (EP): the potential to cause over-fertilisation of water and soil, which can result in increased growth of biomass.

Particulate matter PM10: includes microscopic matter suspended in air or water. Airborne particles are called aerosols. PM10 includes particles less than 10 µm in diameter.

Fine particulate matter PM2.5: same as above but the size is less than 2.5 µm and so called “fine particulate”.



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