A clear-cut path for defining sustainable investments

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Foreword

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With ESG issues now a top strategic priority for businesses worldwide, a pressing challenge for organisations and investors is identifying effective tools to clearly define environmental performance – for better, or worse.

Net zero goals and ambitions are merely aspirations without the right tools and frameworks in place to define business performance and, importantly, to deliver the means to compare measures of success.

Europe has been leading the way on multiple fronts and is considered the trailblazer with its taxonomy for the identification and classification of truly sustainable economic activity. Other jurisdictions, like China and Canada, are also creating their versions of a green taxonomy.

Valuable insights can be taken from each jurisdiction and Australian companies intent on pursuing a more sustainable future can learn from these taxonomies, even as inroads are made towards creating our own definitions that, importantly, will factor in the nuances of the Australian economy.

As a long-term sustainability leader, Westpac has been a dedicated participant in the development of the Australian Sustainable Finance Initiative Roadmap, which draws on the work of these international sustainability standards, and makes 37 recommendations on organisations' sustainable development, screening alignment and disclosure.

Westpac is committed to supporting its customers as they transition and transform their businesses. To that end, we have partnered with Bloomberg to create a content series that encapsulates global lessons on best practice in sustainable finance.

For this first part of the series, our special thanks go to Nathan Fabian, Chief Responsible Investment Officer at the Principles for Responsible Investment and Chair, EU Platform on Sustainable Finance and Sean Kidney, CEO of Climate Bonds Initiative for sharing their insights.

A clear-cut path for defining sustainable investments

To avert a climate catastrophe and achieve a net-zero emissions future, we must make substantial investments in renewable energy as well as a wide range of clean technologies. While the need to act is clear, the path forward is not. Uncertainty boils down to one simple question: How do we know that we are making the right investments?

That question is often difficult to answer. In the five years since world leaders pledged to limit the rise in global temperatures at COP21, there has been a proliferation of 'green' products, investments, and companies around the world. Many carry labels such as 'sustainable' or 'eco-friendly' that do not reflect standard definitions or screening criteria. In turn, investors seldom know what they are getting. This lack of transparency and traceability threatens the integrity of sustainable finance.

“The signing of the Paris Agreement and creation of the UN Sustainable Development Goals has brought sustainability goals into our economies and financial markets,” says Nathan Fabian, Chief Responsible Investment Officer at the Principles for Responsible Investment and Chair, EU Platform on Sustainable Finance.

“If we want financial markets to contribute to our sustainable prosperity, we need investors and financiers to understand how their end investments contribute to, or harm achievement of, the goals. This is why a framework for environmentally sustainable investments is needed.”

In July 2018, the European Commission set up a Technical Expert Group (TEG) of over 200 industry specialists and scientists to tackle that challenge in the European Union. The result is the EU Sustainable Finance Taxonomy – a tool to help corporates and investors understand whether an activity is environmentally sustainable and drive more capital funding into greener economic activities.

With critical Paris Agreement targets approaching, the EU Taxonomy is a gamechanger that could steer Europe towards a net-zero future. Several other countries are also working on sustainable finance taxonomies including Canada, China and Russia.

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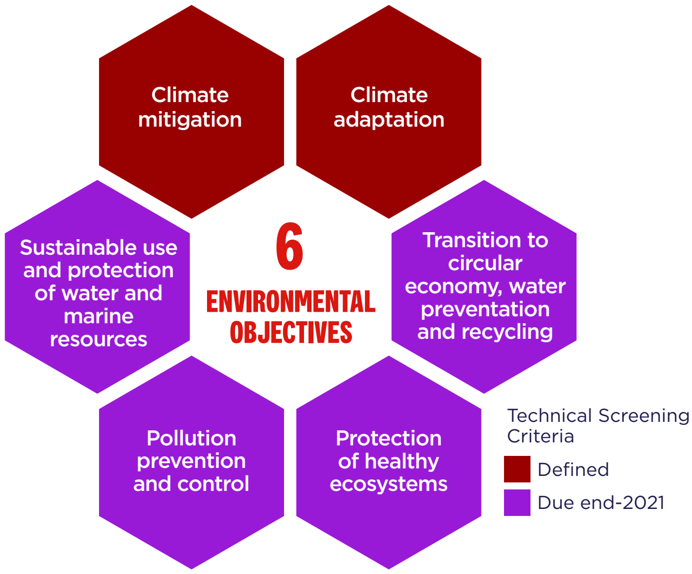
How does the EU taxonomy work?

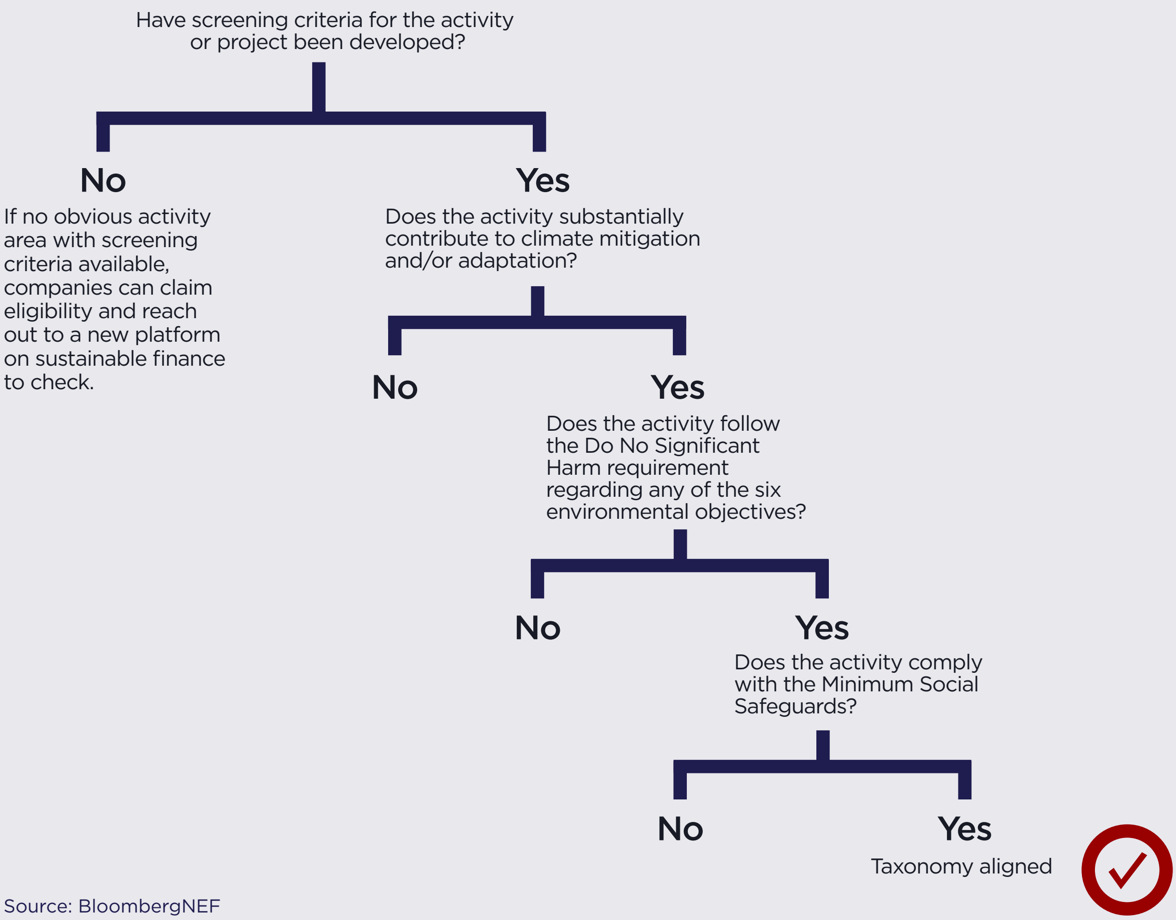
The EU Taxonomy takes the shape of a lexicon that uses science-based practices and thresholds tied to the EU's Paris Agreement commitments to classify environmentally beneficial economic activities. This provides a methodology for determining what qualifies as "green" across eight sectors covering around 85 per cent of EU emissions.

"Sustainability targets, such as those required by the Paris Agreement and SDGs, have united governments and businesses globally," Fabian says. "Being based on the science underpinning the Paris Agreement gives the EU Taxonomy an internationally recognisable platform. This link means investors can easily understand whether their investment practices contribute to the ambition of the Paris Agreement."

If an economic activity is covered by the EU Taxonomy, it must fulfil three requirements for alignment: It has to substantially contribute to at least one of six environmental objectives; it cannot significantly harm any of the other objectives; and it must comply with minimum social safeguards including the UN Guiding Principles on Business and Human Rights, as well as the International Labour Organisation's declaration on Fundamental Rights and Principles at work.



HOW TO DETERMINE ALIGNMENT WITH THE EU TAXONOMY



Source: BloombergNEF

Once all three steps are undertaken, the taxonomy-alignment of an activity – and subsequently a company or portfolio – can be calculated. This helps investors understand how 'green' a company or portfolio is and how it compares to others.

"If you are investing within the EU Taxonomy, you invest in stuff which is necessary to achieve the Paris Agreement," says Sean Kidney, CEO of Climate Bonds Initiative and a former member of the EU TEG on Sustainable Finance.

"In a sense, it is also low risk, because this is more likely to be supported by regulation than be negatively impacted by regulation. And you're seeing investors now saying, right, we are going to refocus and recalibrate our investments towards that universe."

Thus far, the TEG has defined technical screening data for two of the six environmental objectives – climate mitigation and climate adaptation. Regulatory guidelines for the remaining four objectives will be developed by the end of 2021.

"The other four environmental objectives will ensure the main aspects of environmental sustainability are covered by the EU Taxonomy," Fabian says. "The effect will be to further expand the list of activities that companies can attract green finance for.

"Ultimately, we will increase the flow of capital into the environmental solutions and good practices we need to address our most pressing environmental crises. For banks in Europe, the opportunity to have a long list of economic activities to target with green finance is very attractive."

What is expected under the EU taxonomy regulation?

	Scope	Requirements	Deadlines	Further developments
CORPORATIONS	**Companies in scope for the Non Financial Reporting Directive** European listed and large public-interest companies with more than 500 employees and with either a balance sheet total of more than 20 million euros or a net turnover of more than 40 million euros (approximately 6,000 companies).	**Report taxonomy-aligned share of turnover, and opex and capex.** It is usually called the 'green share' of turnover, opex or capex.	**First reporting from January 2022** to cover 2021 financial year for the share that is linked to climate mitigation and adaptation. The share aligned to the four other environmental objectives should be published in 2023, covering financial activity of 2022.	**NFRD is expected to be amended in 2021** via Delegated Acts (detailed legislation) which might change the scope of the directive but won't change the reporting requirements imposed by the Taxonomy. The Taxonomy just uses NFRD to define which companies need to report their taxonomy-aligned green share.
FINANCIAL MARKET PARTICIPANTS	**EU financial participants that sell financial products promoting environmental characteristics** (eg, ESG or sustainable funds) in scope for the regulation on sustainability-related disclosures in the financial services sector.	**Report:** - **Which environemental objective(s)** the financial product contributes to. - **The percentage of investments aligned with the Taxonomy** and the share of enabling and transitional activities, for investments underlying the financial product.	**First disclosures from January 2022.** Any asset managers, even those who are not claiming that their product is sustainable, who are not disclosing this information will have to add the following to their reports: "The investments underlying this financial product do not take into account the EU criteria for environmentally sustainable economic activities."	**The Regulatory Technical Standard was published at the end of January 2021** for the regulation on sustainability-related disclosures (SFDR). It won't impact the disclosure requirements imposed by the Taxonomy regulation.

Source: BloombergNEF

The EU Taxonomy serves as a bedrock for three legislative initiatives: sustainability-related disclosures for investment firms, the Non-Financial Reporting Directive (NFRD) for public companies, and eco-labelling. Mandatory reporting for the first two takes effect in January 2022.

Under the disclosure regulation, investment firms in Europe will need to report the extent to which their products align with the EU Taxonomy. If a firm claims that its products have environmentally sustainable objectives, it will need to disclose the nature and extent to which the product aligns with the EU Taxonomy.

Meanwhile, financial and non-financial companies in Europe under the scope of the NFRD will need to disclose their Taxonomy-alignment for capex and turnover.

This legislation covers approximately 6,000 listed and large public-interest companies.

While European companies are in focus, in some ways the EU Taxonomy transcends borders. For instance, an Australian company with a big footprint in Europe, a European company issuing into Australia, or a purely Australian company with big investors that are based in the EU will all have to use the EU Taxonomy because parties either reporting or doing business in the EU need to follow EU regulations.

Meanwhile, detailed eco-labelling requirements are not yet in place. Further down the line, the European Commission plans to establish a methodology to assess the underlying assets of financial products linked to environmentally sustainable economic activities. That will help determine whether or not an eco-label can be applied to a financial product.

Why does it matter?

The EU Taxonomy aims to foster greater transparency on what Europe considers sustainable. In turn, this helps to answer the critical question that we started with: How do we know that we are making the right investments?

The resulting clarity enables market participants to invest in opportunities in Europe that are closely aligned with Paris Agreement commitments. Furthermore, it reduces the risk of greenwashing, where companies, products or investments are falsely portrayed as environmentally friendly for the sake of marketing.

All told, the EU Taxonomy will facilitate the flow of capital into investment opportunities that bring Europe closer to its net-zero ambitions.

“We already saw some bonds issued against the EU Taxonomy last year in areas that took me by surprise,” Kidney adds. “For instance, we included the retrofitting of gas pipelines to make them ready for green hydrogen, and three bonds have already been issued around that.”

Towards an Australian taxonomy

Today, more than half of all global emissions are covered by a form of governmental net-zero target. That is up from a third just a year ago. Governments around the world are keen to realise the vision set out in the Paris Agreement, yet many do not yet have a clear plan or strategy.

The taxonomy is among the first comprehensive efforts by regulators to tie disclosure requirements to net-zero targets. Thus, the framework, implementation, and outcomes will serve as a model that other countries can follow or use as a benchmark.

“While the EU Taxonomy was not designed to be the de facto standard for financial markets globally, given the weight of investors in the EU who will be governed by the taxonomy, it may have that effect,” Kidney says. “Australia is one market that derives standards and norms from Europe and is too small to develop its own. I believe the Australian market will follow the EU Taxonomy.”

The roadmap released by the Australian Sustainable Finance Initiative (ASFI) in November is a step in that direction.

The roadmap makes 37 recommendations[1] that promise to strengthen Australia’s financial system with the aim of recovering from the impacts of COVID-19 and delivering a transition to a net zero, resource-efficient, and inclusive economy. Among the recommendations are the implementation of a sustainable finance taxonomy to ensure market consistency and clarity for all actors in the financial system.

"Businesses and financiers now need science and evidence-based tools that can help them make sound decisions about financial risk and sustainability performance," Fabian says. "The low carbon transition is happening and the work of ASFI shows that the Australian finance sector knows it.”

[1] ASFI Press Release

Australian businesses are increasingly embracing net-zero. Banks, pension funds, insurers and financial services companies are pledging to end all investment[2] in thermal mines and power stations, making net-zero commitments[3], and urging their portfolio companies to decarbonise faster. Utilities and resource majors are making their own net-zero pledges[4] and aligning with various reporting disclosures. And renewable purchase power agreements continue to gain popularity.

Given BloombergNEF's expectations for a record number of Australian companies to make new sustainability commitments across a wide range of strategies and timeframes this year, developing a clear taxonomy that defines sustainability across financial products may prove crucial. To foster greater clarity and consistency for market participants, Australian authorities should consider a viewpoint on what an appropriate taxonomy would be, drawing on lessons learnt from Europe and other jurisdictions, and potentially adapting to capture the nuances of the Australian economy.

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[2] Bloomberg
[3] Bloomberg
[4] Climate Works