

# EU and Global Taxonomies

Overview and perspectives for Aotearoa New Zealand

Working paper



## Background

The purpose of this report is to highlight for key stakeholders in Aotearoa New Zealand:

- The basics of what a taxonomy is and how it works – a disclosure tool, not government ‘picking winners’, or outlawing activities.
- The significant push globally towards green taxonomies as a building block towards increasing funds available for the climate transition, as well as other environmental objectives.
- That NZ will increasingly stand out if we do not progress a program for a taxonomy, which will bring negative implications for offshore capital flows to NZ.
- Some detail on the EU’s taxonomy program, as it is arguably the most detailed and broad of those currently deployed globally. Further it (along with China’s) is likely to serve as a benchmark / base for other countries globally as taxonomies are rolled out.
- Some potential considerations for NZ both at a general and finance-specific level.

The report is intended to be useful for a wide audience including but not limited to the finance industry, government, academics, iwi, the broader business sector, and individuals interested in sustainability.

Toitū Tahua: Centre for Sustainable Finance welcomes feedback on the report – please send this to [connect@sustainablefinance.nz](mailto:connect@sustainablefinance.nz)

## About Toitū Tahua: Centre for Sustainable Finance

The purpose of Toitū Tahua: Centre for Sustainable Finance, is to accelerate progress towards the Sustainable Finance Forum’s 2030 roadmap for a sustainable and equitable financial system in Aotearoa New Zealand. The Sustainable Finance Forum was founded by The Aotearoa Circle in recognition of the critical role finance plays in achieving and accelerating the transition to a sustainable economy. Its 2030 roadmap, sets out clear recommendations under three themes, ‘changing mindsets’, ‘transforming finance’ and ‘financing the transformation’. [www.sustainablefinance.nz](http://www.sustainablefinance.nz)

## About the author

The primary author of this report is David Lewis. David has over 20 years’ experience in financial markets. He is currently taking a professional break focussing on his young family and retraining in sustainability. His most recent role from 2013-20 was as Portfolio Manager and Deputy Chief Investment Officer at Milford Asset Management. Prior to this he worked at Merrill Lynch in Sydney and London in a variety of areas including research and principal investments. David has a Bachelor of Commerce in Economics from the University of Canterbury, a Master of Commerce in Finance from the University of Sydney, and is a CFA Charterholder. He is enrolled in a Masters in Sustainability commencing late 2022.

The report was produced on a voluntary basis. While care has been taken, the state of play for taxonomies globally has evolved quickly in recent months. The author expects there will be errors and omissions in this report and takes sole responsibility for these. Guidance and assistance has been kindly provided by Jo Kelly, Pip Best, Bridget Coates, David Woods, and Simone Robbers.

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# The bottom line

## What this means for Aotearoa New Zealand

### Aotearoa is lagging

Aotearoa New Zealand is falling behind global competitors. Green taxonomies are already operational, or in development, across much of the world. Progress across Asia is particularly notable.

- China, the EU, the UK, Japan, Singapore, ASEAN, and many others – together almost half (48%) of the world's economy - are either already using or in advanced stages of developing green taxonomies. In cases, this is coming directly from regulators, in others from industry with official support.
- In Aotearoa New Zealand, voluntary standards for agriculture are in use (SAFI - Sustainable Agriculture Finance Initiative) developed by industry in conjunction with government) but there appears to be no clear plan for a broader green taxonomy.

### High cost for not acting

We believe that if the regulatory framework for a green taxonomy is not operational here in the next 1-2 years, there will be negative implications for offshore capital flows to New Zealand. As a reminder, New Zealand's CA deficit in the past 20 years has averaged 3.6% - we need offshore capital.

### Opportunity to break down barriers

Domestically, surveys indicate that a lack of independent information is the number one barrier preventing Kiwis from moving to more value-aligned investment managers, with a lack of trust in managers' ESG claims also a key driver<sup>1</sup>. **A taxonomy in New Zealand has the potential to address this headwind to larger green finance flows in New Zealand.**

### Need for global alignment

**Our small size and the benefits of being internationally aligned** (e.g. capital flows to NZ) **suggest it is inefficient to attempt to develop our own taxonomy bottom-up.** Instead, a global framework and set of technical standards could be used (from the EU or ASEAN for example) as a starting point, with specific Aotearoa New Zealand concepts overlaid. This would best be done in **co-ordination with IPSF and the CGT, to ensure our taxonomy was globally harmonised<sup>2</sup>.**

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<sup>1</sup> RIAA & Mindful Money (October, 2020). *Responsible Investment: New Zealand Survey 2020*, pg. 14.

<sup>2</sup> International Platform on Sustainable Finance (November, 2021). *Common Ground Taxonomy – Climate Change Mitigation*

## The case for starting is clear

Many countries have chosen to proceed with a climate-focussed taxonomy that focuses initially on key sectors, before broadening over time to other sustainability objectives. This would be a sensible approach here also, in our view. More broadly, **we strongly believe it is better to start early with a partial solution than delay and fall further behind** – there is no need to try to develop a complete and perfect system as standards will continue to evolve.

## Integrating te ao Māori

A te ao Māori perspective could theoretically be overlaid to an EU-style framework. Under this structure, achieving full taxonomy alignment in Aotearoa NZ would require satisfying *both* a global/EU and te ao Māori perspective on what is green.

## Cases against a taxonomy

The importance of housing versus equities as asset classes for households, the size of the SME sector, and the dominance of bank financing – all arguments which detractors might use against a taxonomy in NZ - are factors which our research suggests have a similar influence in the EU.

## Potential for innovation

An Aotearoa New Zealand taxonomy would bring potential for various innovations in financial instruments – among the most obvious are ETFs targeting taxonomy alignment (e.g. NZSE50 20%+ or 50%+ taxonomy aligned); taxonomy targets in sustainability-linked bonds and loans; and mutual fund fee linkages. Taxonomy alignment targets could also be introduced to management incentives.

# Summary

## Key points and findings

### What is a taxonomy and what does it do?

- What is a green taxonomy? In short, it is **a labelling system that defines environmentally sustainable economic activities.**
- The somewhat awkward term ‘taxonomy’ has nothing to do with tax. It refers more broadly to a system of classifying things into groups or types. The term was originally used in biology to refer to classification of organisms.
- **A green taxonomy is essentially a disclosure tool. It does not itself restrict or forbid any activities. It allows investors and companies to easily assess which activities and projects are environmentally sustainable** subject to an objective framework.
- It is analogous somewhat to ANCAP safety ratings for cars - it allows stakeholders to reliably assess claims from car manufacturers and dealers regarding their safety (ANCAP); or in the case of a taxonomy, the green credentials claimed by investment managers and companies.

### Why have a green taxonomy?

- As the EC puts it, a green taxonomy is **“a first and essential step in the efforts to channel investments into sustainable activities”**. As a reminder there is an immense quantum of funding needed to transition the global economy away from fossil fuels – for example The International Energy Agency estimates that by 2030 over USD4trillion annually is needed for the energy sector alone<sup>3</sup>. Most of this will have to come from the private sector.
- There is also benefit for SMEs from a green taxonomy, in providing an accessible and reliable guide to what activities are sustainable, and what are not. This is a focus for the ASEAN taxonomy. Similarly **“by clearly defining what is green, the EU Taxonomy seeks to incentivise and encourage companies to launch new projects, or upgrade existing ones, to meet the criteria”**<sup>4</sup>.
- Most taxonomies have not been designed to directly support sustainability disclosures to consumers of end-products (e.g., in the supermarket) and services. **The focus of the EU green taxonomy is very much on the investor as end-user, and thus on its ability to drive transition-enabling investment flows.** The EU continues to develop other regulations for sustainability labelling of consumer products. That said, over time it is conceivable that other uses are found for green taxonomies outside the finance sector.

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<sup>3</sup> IEA (2021). *Net Zero by 2050: A Roadmap for the Global Energy Sector*.

<sup>4</sup> European Commission (April, 2021). *Questions and Answers: Taxonomy Climate Delegated Act and Amendments to Delegated Acts on fiduciary duties, investment and insurance advice*.

## Focus on the EU taxonomy: how does it work?

- This paper details the EU's green taxonomy as it is arguably the most advanced and broad of those currently deployed globally, and it (along with China's) is likely to serve as a benchmark / base for other countries globally as taxonomies are rolled out.
- A key output from the EU's green taxonomy is a **'traffic light' system for categorisation of the environmental impact of activities;**
  - Green – sustainable activities, said to be 'taxonomy aligned';
  - Orange - in transition;
  - Red - unsustainable activity, one that does significant harm to the environment;
- The EU green taxonomy classifies things at the *activity* level – for example 'construction of new buildings', or 'electricity generation from hydropower'.
- **To be categorised as green under the EU taxonomy, an activity must meet four criteria:**
  - i) make a **substantive contribution to one of six environmental objectives** (in short - climate change, circular economy, pollution prevention, biodiversity restoration, water/marine sustainability);
  - ii) do no significant harm ('DNSH') to the other five;
  - iii) meet minimum social safeguards (e.g., human rights);
  - iv) comply with technical screening criteria. These generally are the scientific thresholds / metrics that are used to assess if a given activity is sustainable, or unsustainable.
- There is an allowance for 'transitional activities' – where low-carbon alternatives are not yet available, such as manufacturing cement. Typically for these technical screening criteria are calibrated to require performance in the top tier of an industry (e.g. top 15%, in the case of cement measured on emissions per tonne produced).
- There is also a category for 'enabling activities' that directly enable others to make a substantial contribution to an environmental objective. For example, installation of energy efficiency equipment in buildings.

## What information does the EU taxonomy provide?

- Companies (above a size threshold) are required to use the taxonomy to map out the activities they are engaged in as red, orange, or green. This is then used to calculate splits in three financial KPIs—revenue, capex and opex. The green category or "percentage of (taxonomy) alignment" for each of the KPIs is included in their annual report, or sustainability report. **It shows investors what share of the company's operations are sustainable.**
- In addition, companies need to report a plan that aims to extend the scope of their taxonomy-alignment over time, and other qualitative information about the calculation and changes in the KPIs during the reporting period. In addition, a range of other disclosures are recommended (but not required).
- In turn, **this allows fund managers ,and ETF providers to disclose the % of investments they have that are sustainable** (i.e., taxonomy-aligned), both at a fund and aggregate firm level. This is

seen by the EU as a critical output from the program - investors will be able to see very clearly which fund managers are focussing their investments on sustainable businesses, and which are not, and what the direction and rate of change is. **This will be a critical tool to prevent greenwashing in the investment industry.**

- Similarly, banks will be required to report **what share of their lending and fees come from sustainable activities.**

## Summary of EU taxonomy disclosures across financial institutions

<b>Investment funds - product level</b>	% of portfolio that is taxonomy-aligned by revenue, capex and opex (both inc. and ex sovereign exposures in denominator)
	<i>Enabling and transitional</i> shares
	Recommended – split of the above across the six taxonomy objectives
<b>Asset managers – aggregate level</b>	Green investment ratio - % of taxonomy aligned investments in aggregate; and split across the six objectives
	<i>Enabling and transitional</i> shares
<b>Banks</b>	Green asset ratio - % of taxonomy-aligned on-balance sheet assets , including split across the six objectives, and <i>Enabling and transitional</i> shares
	KPI for trading book and for fees/commissions
<b>Companies</b>	% of business that is taxonomy-aligned by revenue, capex and opex
	10 year plan to increase alignment
	Recommended: splits across the six objectives, share of activities not covered

Source: EC, Toitū Tahua.

## The global state of play

### Taxonomies in other regions

- **China, the EU, the UK, Japan, Singapore, ASEAN, and many others – together almost half (48%) of the world’s economy - are either already using or in advanced stages of developing Green taxonomies.** In cases this is directly from regulators, in others from industry with official support.
- **The US and Australia currently have narrower ambitions,** although both are working on taxonomies of some form. In Australia this is industry-led, with the support of the RBA, and in the US the CFTC has a project underway in respect of derivative markets.
- **Most taxonomies globally are not seeking to map the whole economy** at least initially. The **current focus is generally on key sectors with the largest environmental impact, and on larger businesses.** For example the EU’s program covers the economic activities of roughly 40% of listed companies, in sectors which are responsible for almost 80% of direct greenhouse gas emissions.



- **Agriculture has yet to be covered in the EU’s finalised taxonomy** – there was an intention to include it with the recent gas/nuclear revisions, however it has been postponed until the next round of legislation (‘delegated act’). This is due sometime later this year, but the exact timeframe is unclear. Agriculture was included earlier in the process, for example in the draft Technical Screening Criteria<sup>5</sup>. The EC has noted that earlier delays have been related to “ongoing inter-institutional negotiations on the Common Agricultural Policy”<sup>6</sup>.
- **Both the EU and China are also developing social taxonomies**, to classify activities that provide a significant social benefit, and those that generate significant social harm. These are complex, but are gaining momentum. Europe is also working on a more detailed classification of activities that have a significant negative environmental impact – called an ‘unsustainable’ taxonomy (sometimes referred to as ‘brown’ taxonomy).

### Summary of green taxonomy status in notable countries / regions

Where	Status	Timeframe (indicative)
China	Mainly (at present) used for green bonds	In use since 2015
UK	Accelerated development underway; ambition to be “the best place in the world for green and sustainable investment”	Implementation from 2023-25
ASEAN	Two-tier taxonomy being deployed, with basic and higher thresholds. National regulators governing exact requirements for each member state.	Initial framework in use from Nov 2021
USA	No clear plan for a taxonomy at present; some investigation underway by regulators	N / A
Singapore	Industry led taxonomy in co-ordination with central bank; first draft released Jan 2021	N / A
Australia	Potential development of taxonomy by Australian Sustainable Finance Initiative; no government program at present	Industry targeting 2021-22
Canada	‘Transition’ taxonomy being developed	First draft due shortly
Japan	Mainly (at present) used for green bonds	In use since 2017
Russia	Mainly for green bonds and loans	Introduced in Sep 2021
EU	Wide-ranging green taxonomy already being introduced	Implementation from 2022-24
New Zealand	Voluntary standards for agriculture in use (SAFI - Sustainable Agriculture Finance Initiative – developed by industry in conjunction with government). No current plan for broader green taxonomy.	SAFI phase one guidance released July 2021

<sup>5</sup> European Commission Platform on Sustainable Finance: Technical Working Group. (August, 2021). *Part B – Annex: Full list of Technical Screening Criteria*.

<sup>6</sup> Euro European Commission (April, 2021). *Questions and Answers: Taxonomy Climate Delegated Act and Amendments to Delegated Acts on fiduciary duties, investment and insurance advice*.

# Overview of EU Taxonomy Regulation

## What is a taxonomy?

In short, a taxonomy is robust green labelling, or as described by the European Commission (EC) a “unified classification system on what can be considered an environmentally sustainable economic activity”<sup>7</sup>. **The EC sees it as “a first and essential step in the efforts to channel investments into sustainable activities”<sup>8</sup>.**

Appendix 1 has further detail on the basics of the taxonomy.

## Regulatory background

Development of a green taxonomy is part of the EU’s broader “Sustainable Finance Action Plan” first laid out by the European Commission in March 2018 (following Paris and the UN’s SDGS in 2015).

The goals of the action plan are to:

- Reorient capital flows towards sustainable investment and away from sectors contributing to global warming such as fossil fuels;
- Manage financial risks stemming from climate change, resource depletion, and environmental degradation;
- Foster greater transparency and long-termism in financial and economic activity in order to achieve sustainable and inclusive growth.

## The EU Sustainable Finance Action Plan



Schroders (January, 2021). *How to understand the EU's growing rulebook on sustainable investing.*

<sup>7</sup> European Commission, Financial Stability, Financial Services and Capital Markets Union. (August, 2020). *Renewed sustainable finance strategy and implementation of the action plan on financing sustainable.*

<sup>8</sup> European Commission. (December, 2018). *Financing Sustainable Growth Timeline*

The taxonomy is the cornerstone of multiple regulations impacting company reporting, disclosure, bond issuance, labels, engagement rules and benchmarks. Other key elements are the Non-Financial Reporting Directive (NFRD), Sustainable Finance Disclosures Regulation (SFDR), as well as other green standards and labels. These are discussed in [Appendix 2](#).

## Definition of what is green

To be taxonomy aligned an activity must satisfy four criteria:

- i) **Make a substantive contribution to one of six environmental objectives**
  - climate change mitigation (aligned with neutrality and 1.5 degrees)
  - climate change adaptation,
  - sustainable use and protection of water and marine resources,
  - transition to a circular economy,
  - pollution prevention and control,
  - protection and restoration of biodiversity and ecosystems
- ii) **Do no significant harm (DNSH) to the other five**, where relevant
- iii) **Meet minimum safeguards** (MMS; e.g., OECD Guidelines on Multinational Enterprises and the UN Guiding Principles on Business and Human Rights)
- iv) **Comply with technical screening criteria** – (TSC; note that the process has so far focussed on the two climate criteria as priorities; screening criteria for the other four are still being developed, expected to apply from end-22).

The EC acknowledges that some activities that might appear ‘green’ will not qualify; for example those making important contributions to areas outside of the six.

**It also notes that just because an activity does not qualify does not mean it is unsustainable. Agriculture is an important example of this from a New Zealand perspective.** Further work is ongoing in the EU with respect to agriculture that will determine relevant metrics and thresholds for agriculture to be classified green, orange or amber.

Of note there is also an allowance for:

- **‘Transitional activities’** – where low-carbon alternatives are not yet available and that have greenhouse gas emission levels that correspond to the best performance in the sector or industry. E.g. best-in-class cement manufacturing. Nevertheless, there are two conditions:
  - i) they should not hamper the development and deployment of low-carbon alternatives and
  - ii) they should not lead to a lock-in of carbon-intensive assets, considering the economic lifetime of those assets.
- **‘Enabling activities’** - that directly enable others to make a substantial contribution to an environmental objective. For example, this could include manufacturing of renewable energy technologies, installation of energy efficiency equipment in buildings, research into materials for stronger flood defences. DNSH criteria still apply to these.

## Scope and ambition

The taxonomy is according to the EC meant to provide a ‘gold standard’ – the threshold requires a ‘substantial contribution’, not a marginal contribution for example.

The EC notes that:

- The EU Taxonomy criteria **cover the economic activities of roughly 40% of listed companies, in sectors which are responsible for almost 80% of direct greenhouse gas emissions in Europe**
- “Estimates and early testing of the climate taxonomy criteria show a low overall Taxonomy alignment today in companies’ activities and investment portfolios (**between 1% and 5%, with many companies and investment portfolios standing at zero**)... While this figure is expected to rise significantly with the implementation of the Green Deal, it highlights the extent of the transition still required towards carbon neutrality by 2050

The taxonomy is clearly a dynamic tool – it will evolve significantly over time including via five yearly reviews of the technical criteria. Its proponents emphasise that the starting point includes gaps in coverage, criteria, and has loopholes. This presents challenges for its acceptance but it is clearly a case of the perfect being enemy of the good.

## Traffic light concept

The taxonomy presents an evolving ‘traffic light’ system for categorisation of the environmental impact of activities;

- Green – taxonomy aligned
- Orange – in between
- Red – unsustainable activity, either through breaching DNSH criteria, or potentially as defined in a planned future unsustainable taxonomy.

Note that the taxonomy does not regulate / prohibit any of these activities. It is a disclosure based tool that hopes to drive incremental investment flows in a way that supports ‘migration’ of activities up through the traffic lights – i.e. over time, less harmful activities, more green activities.

Note that thresholds at the activity level (i.e. what qualifies) will rise over time. There are scheduled five yearly reviews beginning (for the green taxonomy) in 2024 - to support relevant transition pathways.

## Comparison with Rio markers for public funds

From 2014-2020, EU Member States have used a percentage for climate tagging (aka “Rio Markers”) to measure the share of ‘green’ in their planned *public sector* investments and reforms.

Three categories are used to assess impact on each of the objectives defined by the EU;

- i) contributes principally (100%)
- ii) contributes significantly (40%)
- iii) has no impact (0%)

In addition, France for example has a tagging system that mirrors the Rio Markers in categorising expenditure impact across the same six categories as used in the taxonomy - climate change adaptation, climate change mitigation, biodiversity, circular economy, water and air quality.

Consultants<sup>9</sup> have noted the taxonomy is a significant improvement on the Rio Markers due to:

- The simplicity of the Rio Markers framework leading to overstating of beneficial climate impacts (overstating the % climate share referred to above);
- They do not consider ‘substantial contribution’ to align the Paris Agreement.

## Recent inclusion of gas and nuclear

Against the intended goal of being a ‘gold standard’, the recent (February 2022) inclusion of natural gas, and to a lesser extent nuclear in the EU’s green taxonomy has been widely criticised, including in respect of politicisation<sup>10</sup> of what was intended to be a science-based process.

How do these qualify in the taxonomy from a technical perspective?

**They have been added as ‘transitional’ technologies**, meaning that they can help the transition towards climate neutrality – by helping phase out the 15% of the EU’s electricity supply still supplied by coal. Indeed the specific criteria in the case of gas require that new plants must replace an existing coal-fired power station and be built by 31 December 2030. They must also satisfy other specific DNSH criteria<sup>11</sup> relating to their efficiency, metrics which have been keenly debated in recent months. For nuclear, new plants must obtain a construction permit before 2045 and show detailed plans to have a disposal facility in place by 2050 for high-level radioactive waste, as well as having accident-tolerant fuels in place – a new technology reportedly not yet deployed. In both cases (gas and nuclear) therefore, the expectation is that a fraction of overall generation capacity will achieve green status in the taxonomy.

The EU’s financial services commissioner, Mairead McGuinness, defended the decision, saying it “may be imperfect, but it is a real solution – it moves us further towards our ultimate goal of carbon neutrality”. From a legislative point of view, this inclusion of gas/nuclear is not yet passed – the European Parliament will vote on it in May. Having been negotiated and through various drafts, the expectation is that it will be passed. This inclusion of gas in particular is a key negative for the integrity of the EU plan. Gas has a role to play in the transition, of course, but to categorise it as ‘green’ (rather than amber, as the EU’s advisory panel had initially suggested) erodes the strength of the broader program. **That said, we still see the EU’s overall taxonomy program as a positive and a crucial step in support of increased flows of crucial sustainable financing over time.**

## Activity examples in practice

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<sup>9</sup> Cotr, Climate Strategy and Climate & Company (2020). *Applying the EU Taxonomy: Lessons from the Front Line*.

<sup>10</sup> To generalise, negotiating positions reflected countries’ existing energy sources; France was pro-nuclear; while Germany and countries in southern and eastern Europe were pro-gas.

<sup>11</sup> New gas facilities must also be designed to run 100% on renewable or low-carbon fuels by 31 December 2035 and contribute to “a reduction in emissions of at least 55%” over their lifetime. Direct emissions must be lower than 270g CO<sub>2</sub>e/kWh or must not exceed an average of 550kg CO<sub>2</sub>e/kWh over 20 years.. [EU Puts Green Label for Nuclear and Gas Officially on the Table](#)












A detailed discussion of criteria across sectors is outside the scope of this paper however a couple of examples helps provide context for how the taxonomy works in practice. This is taken from the EU's 'Taxonomy Compass' – a search tool for activities / criteria.

Criteria simplicity has been targeted - the intention was to 'establish the criteria in a single line'. The current draft list of criteria runs to 993 pages however<sup>12</sup>, with 14 pages on leather tanning for example. Criteria are science-based and attempt to set industries on a path consistent with the EU's climate and environmental goals, based on currently available technologies.

## Mapping by activity

Although screening criteria are still in development outside of climate (i.e. for four of the six categories), the below from the TEG's final report is an indication of how it will look once complete. Note that most activities will have several potential avenues (i.e. among the six environmental objectives) to reach the 'substantial contribution' threshold.

Technical screening criteria are provided for economic activities within the following sections:

Classification		Environmental Contributions							
NACE Macro-sector	NACE Activity	1. Climate change mitigation (Substantial Contribution)			2. Climate change adaptation (DNSH)	3. Water (DNSH)	4. Circular economy (DNSH)	5. Pollution (DNSH)	6. Ecosystems (DNSH)
		Own performance	Enabling activities	Transitional activities					
	Afforestation	✓			✓	✓		✓	✓
	Rehabilitation, reforestation	✓			✓	✓		✓	✓
	Reforestation	✓			✓	✓		✓	✓
	Existing forest management	✓			✓	✓		✓	✓
	Conservation forest	✓			✓	✓		✓	✓
	Growing of perennial crops	✓		✓	✓	✓	✓	✓	✓
	Growing of non-perennial crops	✓		✓	✓	✓	✓	✓	✓
	Livestock production	✓		✓	✓	✓	✓	✓	✓
	Manufacture of low-carbon technologies		✓		✓	✓	✓	✓	✓
	Manufacture of Cement	✓		✓	✓	✓	✓	✓	✓
	Manufacture of Aluminium	✓		✓	✓	✓	✓	✓	✓

<sup>12</sup> European Commission Platform on Sustainable Finance: Technical Working Group. (August, 2021). Part B – Annex: Full list of Technical Screening Criteria.

## Example – Manufacturing aluminium

Q Aluminium

Sector	Activity	Climate mitigation	Climate adaptation	Water	Circular economy	Pollution prevention	Biodiversity
Manufacturing	<a href="#">Manufacture of aluminium</a>	+	+				

### EU Taxonomy Compass

- As mentioned above, the focus has been climate and criteria are still under development for four of the six categories – hence the blank spaces for Water, Circular economy, pollution prevention and biodiversity in the above screenshot from the EU Taxonomy Compass website.
- To qualify for the taxonomy's *climate mitigation* criteria the manufacturer has to achieve the absolute thresholds below for emissions intensity. Typically these are aligned with top 15% relative performance within the industry.

### EU Taxonomy compass search results for Manufacture of aluminium contribution to climate mitigation

Manufacture of aluminium contribution to climate mitigation

Description

Substantial contribution criteria	Do no significant harm criteria
<p>The activity manufactures one of the following:</p> <p>a. primary aluminium where the economic activity complies with two of the following criteria until 2025 and with all of the following criteria<sup>(105)</sup> after 2025.</p> <p>(i) the GHG emissions<sup>(106)</sup> do not exceed 1,484<sup>(107)</sup> tCO<sub>2</sub>e per ton of aluminium manufactured<sup>(108)</sup>;</p> <p>(ii) the average carbon intensity for the indirect GHG emissions<sup>(109)</sup> does not exceed 100g CO<sub>2</sub>e/kWh;</p> <p>(iii) the electricity consumption for the manufacturing process does not exceed 15.5 MWh/t Al.</p> <p>a. secondary aluminium.</p>	<p>Climate adaptation</p> <p>Water</p> <p>Pollution prevention</p> <p>Biodiversity</p>
Minimum safeguards	

## Example – Buildings

### Key points<sup>13</sup>:

- Relative concept - the general position is that buildings in the top 15% by efficiency/ annual energy consumption (ignoring embedded carbon) will be considered taxonomy-aligned;
- A renovation that improves the building's efficiency performance such that it now qualifies for the top 15% would result in that building's full value being considered taxonomy-aligned (in a % of portfolio value calculation);
- If a renovation fails this threshold (top 15%), but achieves a 30% improvement in efficiency, then the value of that renovation (rather than the full building value) will qualify as taxonomy-aligned;

<sup>13</sup> Climate Bonds Initiative Podcast. (April 2020). EU Taxonomy Explored – Buildings

- Commentators have emphasised the problems and challenges with data in this sector - despite existing national level data frameworks in the EU, these are not standardised.

## Data history

Data providers are developing time series of corporates' taxonomy alignment – for example S&P's Trucost claim to have data back to 2005<sup>14</sup>. Given the very recent nature of technical screening criteria there are no doubt deep assumptions at the activity level within this so the quality of these data is likely to be questionable, in our view.

## What disclosure will look like

Disclosure under the taxonomy covers three broad groups:

- i) Companies – those that fall under the scope of the NFRD / CSRD (all European listed companies, non-listed companies with assets > €20m, Revenues > €30m, Employees > 500). See Appendix 2 for more detail on NFRD / CSRD.
- ii) Investment products – from all FMPs (Financial Market Participants – banks, assets managers, insurance companies). Note as discussed below, if a product is not making any claim to 'green' or responsible credentials it can largely opt out of taxonomy disclosure.
- iii) Public sector

These groups are discussed below long with some key sub-categories e.g. banks.

Note that there is little to no mention in the EC's material, or third party analysis, of companies potentially using the taxonomy as a green label at the product/ activity level – for example to reflect sustainability credibly to consumers. There are other regulations being developed to support this (briefly discussed in Appendix 2). **The focus of the green taxonomy is very much on the investor as end-user, and thus on its ability to drive transition-enabling investment flows.**

## Company level disclosure

Companies will report:

- A “percentage of alignment” across three KPIs – revenue, capex, and opex. This would be included as part of an annual report or sustainability report;
- a *plan* at the economic activity aggregated level that aims to extend the scope of taxonomy-aligned economic activities, or for activities to become taxonomy-aligned within a period of maximum 10 years;
- accompanying qualitative information about the calculation and the key elements for change of the three KPIs during the reporting period.

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<sup>14</sup> Standard and Poor's Global. (October 13, 2020). Trucost launches EU Taxonomy Revenue Share dataset.



The inclusion of capex is intended to help investors identify those companies that are investing for the future in a sustainable way, as opposed to the makeup of their current operations. Taking revenue as an example, companies would report taxonomy aligned revenues divided by total revenues. There are four steps to achieve this, reflecting the four criteria discussed earlier<sup>15</sup>;

- i) **Be Eligible:** Identify the eligibility of the revenue source activity by using NACE macro-sector codes (as for projects);
- ii) **Demonstrate Alignment:** Apply the technical threshold criteria to determine if activity delivers a substantial contribution to climate action (TEG-recommended thresholds, as for projects);”
- iii) **Do No Significant Harm:** Undertake diligence to ensure activity does no significant harm to other environmental areas; listed companies are obliged to disclose breaches of environmental regulations, which together with sustainability reports can cover these requirements; and
- iv) **Comply with Minimum safeguards:** Apply minimum social safeguards (again, usually companies comply with workers’ rights in operation jurisdictions, and report against SDGs).<sup>16</sup>

*[NACE codes = EU’s Standard Industry Classifications. TEG = technical expert group]*

Companies ‘should’ (i.e. guidance suggests, but this is not mandatory) also:

- “Provide for a breakdown of the KPIs based on the economic activity pursued, including transitional and enabling activities, and the environmental objective reached”;
- Disclose the share of economic activities that are not covered by the Taxonomy;
- Projects can also be disclosed separately.

## Investment product disclosure

Final draft guidance was released late October 2021. After some debate leading to delays around treatment of sovereign exposures (for which no taxonomy exists) it is now expected that fund level KPIs will need to be disclosed both including and excluding sovereigns from the denominator. Thus required (in graph format) disclosures across each KPI of portfolio revenue, capex and opex are:

- % of investments taxonomy-aligned as % of total (total including sovereign)
- % of investments taxonomy-aligned as % of total (total excluding sovereign)

In addition:

- Breakdown of enabling and transitional activities of Taxonomy aligned investments
- Whether a third party audited the compliance with the Taxonomy
- The share of sustainable investments with an environmental objective other than the six Taxonomy objectives (i.e. environmentally sustainable, but not Taxonomy aligned)
- Allocation of socially sustainable investments must be provided (in the absence of a social Taxonomy at present).

An allowance for estimates at fund level is made, given funds are required to start reporting 18 months before companies. **This is likely to lead to questions surrounding comparability and relevance of initial fund reporting.**

<sup>15</sup> Climate & Strategy Partners, Climate & Company. (2020). “Applying the EU Taxonomy”: *Lessons from the Front Line*

<sup>16</sup> EU Technical Expert Group on Sustainable Finance (2020). Taxonomy: Final report of the Technical Expert Group on Sustainable Finance.

## Bank disclosure

For banks the focus is on the lending portfolio; requirements per the EC's guidance note<sup>17</sup> are:

“Credit institutions shall report a main KPI for on-balance sheet assets related to the financing activities (e.g. lending activities). They should report as well KPIs for off-balance sheet assets and, subject to a phase-in period (see Question 11), a KPI for commissions and fees related to other non- financing activities and, where relevant, a KPI for their trading book.

The main KPI for credit institutions is the Green Asset Ratio (GAR) that is defined as the proportion of the credit institutions' assets invested in taxonomy-aligned economic activities as a share of total covered assets.

The GAR should be calculated based on the on-balance sheet exposures (total covered assets) according to the prudential scope of consolidation for the types of assets. Credit institutions should disclose the aggregate GAR for on-balance sheet covered assets and provide for a breakdown for the environmental objective pursued by environmentally sustainable assets, the type of counterparty, and the subset of transitional and enabling activities”.

## Asset managers disclosure

In addition to required product level disclosures:

“Asset managers should report the proportion of taxonomy-aligned investments managed by an asset manager in the value of all covered assets under management from both its collective and individual portfolio management activities (Green Investment Ratio) 12 .

The weighted average of taxonomy-aligned investments should be based on the share of taxonomy-aligned economic activities of investee companies. Asset managers shall rely on the underlying investee companies' KPIs to compute their own Green Investment Ratio.

Asset managers shall in addition provide for a breakdown for each environmental objective and for aggregated environmentally sustainable economic activities, a subset of transitional and enabling economic activities and the type of investments”<sup>17</sup>

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<sup>17</sup> European Commission: “What is the EU Taxonomy Article 8 delegated act and how will it work in practice?” Q3 2021

## Other disclosures

### Insurance / reinsurance disclosure

“Insurance or reinsurance undertakings shall disclose the KPIS related to their investments and underwriting activities. The investment KPI relates to the investment policy of insurers and reinsurance undertakings for the funds resulting from their underwriting activities. The underwriting KPI relates directly to their underwriting activities.”<sup>18</sup>

### Disclosure by foreign companies and SMEs

The EC notes that “Other companies (e.g. SMEs, non-EU companies) may decide to disclose this information on a voluntary basis for the purpose of getting access to sustainable financing or for other business-related reasons”.<sup>18</sup>

### Disclosure summary

We summarise the above in the following table:

Investment funds - product level	% of portfolio that is taxonomy-aligned by revenue, capex and opex (both inc. and ex sovereign exposures in denominator)
	<i>Enabling and transitional</i> shares
	Recommended – split of the above across the six taxonomy objectives
Asset managers – aggregate level	Green investment ratio - % of taxonomy aligned investments in aggregate; and split across the six objectives
	<i>Enabling and transitional</i> shares
Banks	Green asset ratio - % of taxonomy-aligned on-balance sheet assets , including split across the six objectives, and <i>Enabling and transitional</i> shares
	KPI for trading book and for fees/commissions
Companies	% of business that is taxonomy-aligned by revenue, capex and opex
	10 year plan to increase alignment
	Recommended: splits across the six objectives, share of activities not covered.

<sup>18</sup> EU Technical Expert Group on Sustainable Finance (2020). Taxonomy: Final report of the Technical Expert Group on Sustainable Finance.

## Timeline

The first requirement for product related disclosures begins in January 2022. Disclosure across the various groups is shown below. Full implementation is not until 2025. Note, a review of technical screening criteria is schedule for December 2024.

	2022*	2023	2024	2025
Corporates (CSRD)				
Investment firms				
Asset managers			***	
Insurers	KPI underwriting			
	KPI Assets		***	
Credit institutions	Main GAR			
	Additional KPIs**		***	

\*Entry into force: 1 January 2022, reporting based on previous FY e.g. 2021 data for 2022 reporting

\*\*Trading book and Fees and Commissions delayed to 2026

\*\*\*Reporting for financial holdings may only account eligible data from previous FY, aligned in 2025

Taxonomy eligible data

Taxonomy-aligned data

Mix according to holdings

Climate Bonds Initiative. (July 20, 2021). Webinar : The EU Platform on Sustainable Finance presents: What it means for BANKS.

## Future development in the EU on unsustainable, neutral and social taxonomies

### Unsustainable and neutral taxonomy

Europe is developing an unsustainable taxonomy, that is, a list of environmentally unsustainable activities. The EC refers to these as ‘SI’ – significant impact.

Note, while it is reasonable common to find industry references to the term ‘brown’ taxonomy, the EC has “has chosen to firmly reject a ‘brown’ taxonomy, because of the inappropriate ethnic reference and because, when talking about brownfield and greenfield investments, the interpretation can be the opposite”.

This may also include a ‘Neutral taxonomy’, i.e. a list of activities with no significant impact (NSI) on the environment .

Timeline: Consultation summary released July 21<sup>19</sup>; final report making recommendations to EU Commission due in December 2021.

<sup>19</sup> European Commission Platform on Sustainable Finance. (July 2021). Public Consultation Report on Taxonomy extension options linked to environmental objectives. Pg. 14.

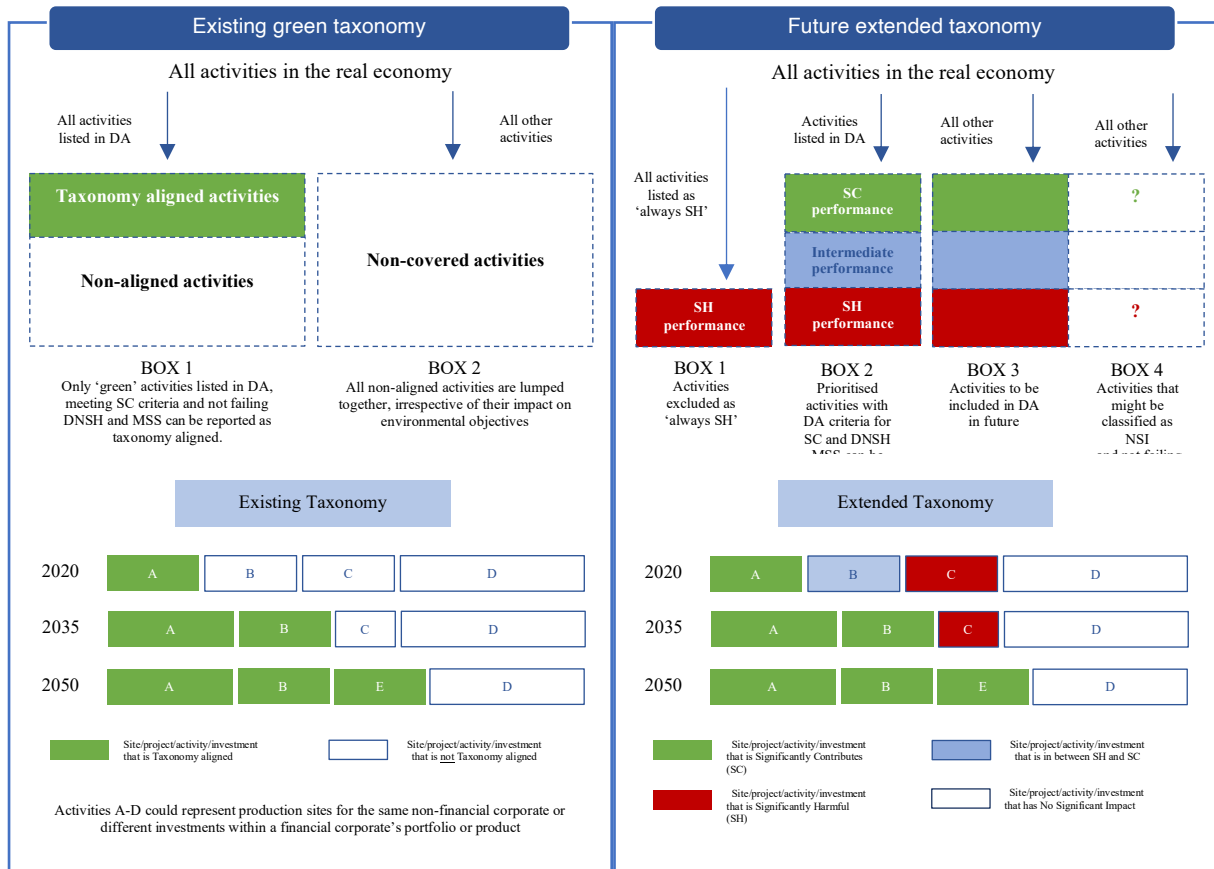
Implications:

- Addresses the “binary classification problem” of a green taxonomy; i.e. some will incorrectly assume that if something is not eligible for the green taxonomy then it is unsustainable;
- could support a more standardised approach to exclusion policies / data especially for funds claiming sustainable credentials;
- could thus deter engagement with high emission sectors.
- Fitch ratings notes<sup>20</sup> banking regulatory support for the proposal (ECB, BoE) given ability to increase risk weights for unsustainable activities; contrasting opposition from regulators for “preferential lending requirements for activities marketed as “green” – which they believe could create financial stability risks.

Comment: summary section of the July release indicates more support for SI than NSI extension given the balance of complexity vs benefits. Eurosif’s commentary has a similar conclusion<sup>21</sup> and they continued to see the green taxonomy as priority.

Coverage of activities in the economy under the existing and future taxonomies is shown below. In particular note the clearer definition of ‘orange’, or ‘intermediate performance’ aspect of the ‘traffic lights for sustainable finance’.

Extension of the Taxonomy can facilitate clarity and improved understanding of environmental performance of portfolios of activities and can thereby support improved transition strategies and access to financing. Source: European Commission Platform on Sustainable Finance. (July 2021). Public Consultation Report on Taxonomy extension options linked to environmental objectives.



<sup>20</sup> Fitch Ratings. (18 December, 2020). “Brown” Taxonomy Could Standardise Negative ESG Screening.

<sup>21</sup> Eurosif. (6 September, 2021). Social Taxonomy and extended Environmental Taxonomy – Eurosif position.

## Social taxonomy

Timeline: Alongside the environmental extension; i.e. consultation summary released July 21<sup>22</sup>, final report final report making recommendations to EU Commission due in December 2021.

Background: Funds emphasising social impact that are rightly Article 8 (i.e. 'light green') may come out poorly on taxonomy alignment. Thus managers have been looking to define their own criteria for what sustainable social investments look like – a social taxonomy would standardise and solve this.

Structure:

Akin to the green taxonomy, it would seek to answer:

- what constitutes a substantial social contribution;
- how to not do significant harm;
- what activities are harmful.

Both 'vertical and horizontal'<sup>23</sup>

- "vertical dimension focusing on products and services for basic human needs and basic infrastructure";
- "horizontal dimension takes into account impacts on different groups of stakeholders affected by economic activities – workers, including value chain workers, consumers and communities".

Comparison to environmental taxonomy: The draft report identified four key differences:

- i) Economic activities such as job creation are inherently socially beneficial. A social taxonomy has to distinguish between these inherent benefits and added social benefits such as improving access to quality healthcare or ensuring decent jobs.
- ii) Environmental objectives and criteria can be based on science, but a social taxonomy could be founded on international authoritative standards of topical relevance such as the International Bill of Human Rights.
- iii) The environmental taxonomy links criteria to economic activities. However, some social aspects, such as collective bargaining or tax transparency, cannot be linked to economic activities. Rather, they must be linked to the economic entity.
- iv) For some social topics it might be more difficult to develop meaningful quantitative criteria.

Comment: Clearly earlier in development and arguably more complex. Will be likely more politically sensitive. More detailed commentary from Freehills can be read here: [The EU is defining green business – now it has social factors in its sights | Herbert Smith Freehills | Global law firm.](#)<sup>24</sup>

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<sup>22</sup> European Commission Platform on Sustainable Finance. (July 2021). Public Consultation Report on Taxonomy extension options linked to environmental objectives.

<sup>23</sup> European Commission Platform on Sustainable Finance. (July 2021). Draft Report by Subgroup 4: Social Taxonomy.

<sup>24</sup> Antony Crockett, Herbert Smith Freehills. The EU is defining green business – now it has social factors in its sights.





## Applying the taxonomy to banking products

Timeline: Appears still early stages from regulatory perspective however significant industry work has been undertaken in co-ordination with UNEPFI and EBF, European Banking Federation.

- Specifically 80 page report including recommendations released by UNEPFI/ EBF in January 2021<sup>25</sup>;
- ‘Phase 2’ work is now underway seeking to “to develop industry guidelines, standard templates and product-centric approaches to operationalize the EU Taxonomy”

Detail:

- Products being assessed cover retail, business, institutional;
- 26 banks in case study done in 2020

26 published case studies			
	<p><b>Banking products</b></p> <ul style="list-style-type: none"> <li>• Corporate loans incl. general purpose loans and loans with UoP</li> <li>• SME loans</li> <li>• Green bonds</li> <li>• Syndicated credit facility, RCF</li> <li>• Sustainability linked loans</li> <li>• Export finance guarantee, project finance</li> <li>• Trade finance guarantee, supply chain finance</li> </ul>		<p><b>EU Taxonomy alignment</b></p> <ul style="list-style-type: none"> <li>• Strictly aligned: ii 0</li> <li>• Aligned with assumptions: iii 7</li> <li>• Partially aligned: iv 8</li> <li>• Not aligned or not aligned yet: 4</li> <li>• Inconclusive: 7</li> </ul>
	<p><b>Sectors</b></p> <ul style="list-style-type: none"> <li>• Real estate</li> <li>• Transportation</li> <li>• Manufacturing</li> <li>• Forestry</li> <li>• Energy</li> <li>• Telecoms</li> </ul>		<p><b>Geographies</b></p> <ul style="list-style-type: none"> <li>• EU based (75%)</li> <li>• Non-EU (25 %)</li> </ul>

### KEY

- i. The total number of case studies used to inform the report is larger and based on over 40 live or recently closed transactions and existing client relationships.
- ii. No assumptions made, all relevant data available
- iii. Aligned with Assumption: SC TSC could be ascertained through available data, compliance with MSS and DNSH could not be ascertained through available data but was assumed, in alignment with relevant regulatory obligations that the company / asset has to follow.
- iv. Partially aligned: Only some of the TSC for SC and/or DNSH and/or MSS could be ascertained, and the use of assumption was not possible, for a variety of reasons. See details for each case study outcome.

<sup>25</sup> UNEP Finance Initiative. (January 2021). Testing the application of the EU Taxonomy to core banking products: High level recommendations

Comment: The benefits of expanding the taxonomy to banking are clearly immense given their importance as capital providers. It is clear that this could really accelerate/embed mainstreaming of sustainability. There are a number of challenges of course including data, unspecified use of proceeds, etc.

Of note from an Aotearoa New Zealand context, a couple of observations are made on retail banking products in the report;

- **“Retail lending is where banks see a wide gap between their existing practices and internal framework, and the EU Taxonomy.** The unanimous view is that the EU Taxonomy was not devised for the retail banking market and the processes required to apply it are not suited to the features of retail lending products. However, the issues appear less acute for some industry sectors, such as real estate, where the Environmental Performance Criteria (EPC) rating scheme will facilitate the application of the EU Taxonomy. Nonetheless, while this is helpful in order to meet Substantial Contribution TSC (technical screening criteria), it does not cover TSC for DNSH or MSS (minimum social safeguard) requirements.”
- Despite challenges, progress was made: “application of the EU Taxonomy to retail loans, trade finance transactions and general purpose facilities—the latter constituting well over 50% of a typical bank’s balance sheet/revenue stream—was particularly testing for banks, which **nonetheless managed to develop early stage methodologies to address these specific challenges.**”



# Implications of taxonomy for European Union asset managers

## High level observations

- **Gradual impact on financing flows** – it will take time before end-clients fully understand new disclosures and differentiate funds / change existing investments;
- larger flows to transition enabling companies and technologies over time;
- **greater regulatory burden, related criticism from detractors.** Especially for corporates - activity focus of the taxonomy is needed however this may be difficult for many companies facing a complicated matrix of existing product/ revenue reporting, compared to taxonomy *activity level* definitions;
- **compliance cost favours scale** – relative support for larger fund managers;
- **reduced greenwashing;**
- **EU capital flows biased towards Europe and away from offshore jurisdictions where taxonomy criteria cannot be applied;**
- **potential crowding into companies with high taxonomy alignment**, especially large cap/ quality companies (as managers potentially use these to lift overall portfolio green ratio)- deepening of ‘greenium’ on these companies.

## Challenges for asset managers

The following table presents some challenges notes by European commentators,<sup>26</sup> along with our own comments and observations relating to these:

Issue	Our view / mitigants in potential application
<p><b>Changing criteria</b> - The technical screening criteria are not static – they change every 5 years. Makes sense (if not more frequently) but creates issues for illiquid investments e.g. infrastructure, real estate.</p>	<p>Seems manageable;</p> <ul style="list-style-type: none"> <li>i) grandfathering for a period after criteria changes would assist rotation/ improvement in illiquid assets;</li> <li>ii) products should be designed with a safety threshold (e.g. if 60% Green needed for a certain commercial accreditation then fund should aim higher to allow for this risk)</li> </ul>
<p>Interaction of EU Sustainable Finance Disclosure Regulation (SFDR) with Taxonomy assessment (uses look through i.e. proportional calculation on the sustainability of specific economic activities/business lines of the company)</p>	
<p><b>Monitoring</b> - Is it sufficient to make sure that the investee companies have the right policies and procedures in place? Or do managers need to monitor the application of such policies/procedures in practice? And what should the level of such monitoring be?</p>	<p><b>Seems a key challenge.</b> Presumably a need over time for <b>much deeper assurance industry for green credentials</b> – a positive development</p>
<p><b>International application / investments</b> – should asset managers have to use equivalent regimes offshore, or get offshore investments attested under the taxonomy?</p>	<p>Key for capital flows to NZ clearly.</p>
<p><b>Quality comparable data</b> – “the EU regulator recognises this and tries to address the challenge by imposing disclosure obligations on the downstream part of the investment chain (e.g. by broadening the scope of the Non-Financial Reporting Directive/NFRD), [however] the landscape remains patchy. E.g. small private investments are excluded.</p>	<p>Data will improve over time –something is better than nothing. On the specific example - small private investments are a very small part of most larger portfolios / overall savings pools - so this particular ‘problem’ is typically not a big one.</p>
<p><b>Potential low alignment risks making the taxonomy a ‘meaningless data point’.</b> Recall EC estimates most fund are currently 0-5% aligned.</p>	<p>Data will improve over time and the hope is consumer pressure will drive higher alignment</p>
<p><b>‘Incredibly tight’ implementation deadlines</b> both for SFDR and taxonomy</p>	<p>Fast approach is correct - given urgency of change needed, it is better to get moving and underway rather than wait for perfectly designed regulation</p>
<p><b>Lack of ‘cross-functional depth of ESG knowledge’</b> e.g. in investment, product, reporting teams within asset managers</p>	<p>This would be worse in NZ. Highlights need for training to catch up.</p>

<sup>26</sup> Julia Vergauwen, Linklaters. (29 September, 2021). EU Taxonomy - challenges for asset managers  
Sarah Hedges & Troy Mortimer, Alpha. SFDR & EU Taxonomy: The 10 Key Challenges Facing Asset Managers Right Now.

# Perspectives for Aotearoa New Zealand

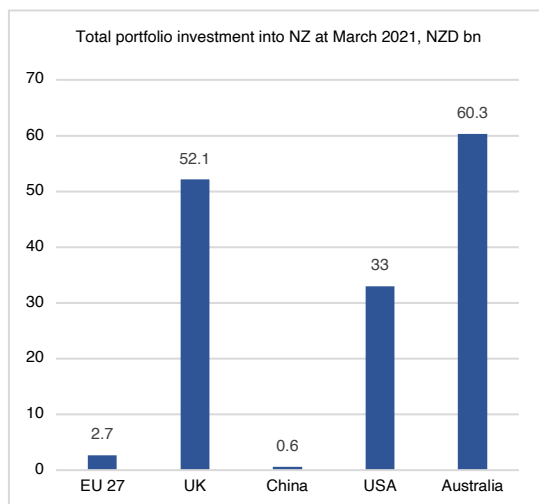
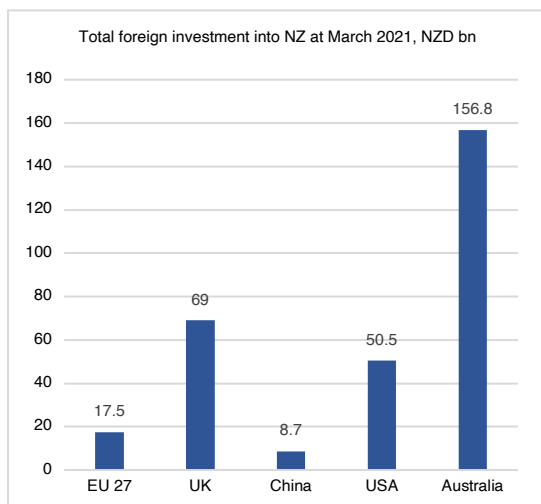
## Benefits of a green taxonomy

The European Commission points to the following benefits for its green taxonomy:

- Creates a frame of reference for investors and companies;
- supports companies in their efforts to plan and finance their transition;
- helps mitigate market fragmentation (i.e. with a single European framework rather than country level);
- protects against greenwashing;
- accelerates financing of those projects that are already sustainable and those in transition - can help scale up investment in green projects that are necessary to implement the European Green Deal.

Aside from national fragmentation, these all apply in New Zealand. Other key factors in New Zealand include:

- **Access to offshore capital** – NZ’s CA deficit in the past 20 years averaged 3.6%, compared to Europe’s 1.1% surplus. **If NZ does not achieve international taxonomy alignment it will increasingly drive higher cost and less availability of international capital.** This appears likely to be a process over many years; however it could accelerate.
- **European portfolio flows are a nearer-term risk;** should the taxonomy deter European portfolio flows from NZ. EU-27 investment in NZ is relatively low compared to other regions, however – stats NZ reports portfolio investment at NZD2.7bn. Investment from the UK is much larger – this is important given the UK’s own taxonomy implementation (potentially faster than the EU).



Stats NZ, 2021

- **Less developed sustainability frameworks in NZ’s local capital markets** and investment industry (compared to Europe), meaning there is more ground to catch up faster. As one tangential example, PwC reports that 26% of NZ’s largest 100 listed companies reported scope 1,2 and 3 emissions, compared to 49% of European corporates in the TCFD’s 2020 study .

## Potential for a EU-style taxonomy in Aotearoa New Zealand

As discussed further below (see *Global harmonisation of taxonomies*), our current view is that NZ's best route to adopting a taxonomy would be to co-ordinate with IPSF and the CGT;

- With China and the EU on board the CGT clearly has the potential to become a global benchmark if executed well;
- NZ's small size suggests it is inefficient to attempt to develop our own taxonomy bottom up. **Instead, a global set of technical standards and framework could be used (such as the EU's) as a starting point and then some specific NZ concepts overlaid.**

## Te Ao Māori / Te Tiriti

Toitū Tahua believes that Māori perspectives on a taxonomy would need to be developed in consultation with iwi. This has not been undertaken to date.

That said, from a more technical / design perspective, it is interesting to consider how a te ao Māori perspective could be theoretically *overlaid* to an EU-style framework;

- Use the EU's existing framework as a base– e.g. six environmental targets (for SC testing), SH conditions, etc;
- Add a seventh parameter – a list of activities / outcomes that represent a significant contribution in Aotearoa from a te ao Māori perspective. This list to be determined by Māori, respecting tino rangatiratanga;
- Similarly add a list determined by Māori on additional significant harm activities (i.e. expanding the EU list);
- To achieve taxonomy alignment in NZ would require satisfying all of the above parameters (in simple terms, *both* a global/EU *and* te ao Māori perspective on what is green);
- This has the potential to provide some alignment with several established principles in Te Tiriti including partnership, active protection, consultation, biculturalism;
- However, offshore users could if they chose focus on the underlying EU framework and thus effectively consider alignment within their own jurisdiction's requirements - or they could use the NZ framework/disclosure to respect domestic views if they desired;

As noted by David Woods, at COP 26, there is also scope to co-ordinate with existing frameworks such as Treasury's He Ara Waiora, as well as benefit for Aotearoa New Zealand in considering how other countries may be tackling First Nations issues<sup>27</sup>.

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<sup>27</sup> David Woods, Toitū Tahua: Centre for Sustainable Finance. (November 7, 2021). CO26 Update from David Woods.

## Potential arguments against a taxonomy in Aotearoa New Zealand

Below we consider factors that could, especially at first glance, be put forward to argue that a green taxonomy would not suit NZ. In addition we argue and present evidence to rebut these points:

### Dominance of housing as an investment

If NZ households are much more focussed on housing as an investment class, does that mean that a taxonomy that seeks to largely drive the investment industry is less relevant for NZ?

- In fact housing is also a very important asset class for European households— 49.9% of their household net wealth;
- In NZ, the RBNZ reports this as just 37.3%, but adjusting for farms and trusts a figure of circa 60% is more plausible (refer Appendix 4 for detail on household balance sheets).
- **The key point is that a high household wealth allocation to housing – in Europe as in NZ – should not be a reason to avoid a taxonomy.**

### Relevance of equity investments

Related to the above, detractors may argue that kiwis don't invest that much in the shallow local share market.

- Of note NZ households have 35% of GDP invested in mutual funds (dominated by KiwiSaver – which of course will be much bigger over time), against 19% in Europe;
- Of course insurance products are also more popular in Europe; however direct equity investment in NZ are also proportionally higher (58% vs 10%);
- Taking insurance, funds, and listed equity investments together, European and NZ household balance sheets are not dissimilar – 20% of NZ household wealth is in these products, against 24% in Europe;
- The overall picture is that NZ household participation in the equity market is at least as large (in relative terms) as in Europe – **so a taxonomy to help households drive better sustainability behaviour through their investments is just as important here.**

EU vs NZ household balance sheet – refer to Appendix 4 for more detail

ADJUSTED FOR FARM/ HOUSING RECLASSIFICATION	NZ			EU			2020	
	% of household net wealth	% of GDP	NZD bn	% of household net wealth	% of GDP	NZD bn	EURbn	EU vs NZ multiple
Insurance, pensions and standardised guarantees	6.1	40.4	130	16.9	72.5	17,431	10,633	134
Currency and deposits	9.8	65.5	211	16.4	67.1	17,131	10,450	81
Equity in mutual funds	5.3	35.1	113	4.8	19.5	4,911	2,996	43
Listed shares	8.7	57.8	186	2.4	9.7	2,438	1,487	13
Unlisted shares / shares in unincorporated businesses	9.5	63.4	204	4.0	16.3	4,098	2,500	20
Other shares	0.0	0.0		4.0	16.5	4,141	2,526	
<b>Total equity and investment fund shares</b>	<b>23.4</b>	<b>156.2</b>	<b>503</b>	<b>15.2</b>	<b>62</b>	<b>15,592</b>	<b>9,511</b>	<b>31</b>
Other accounts receivable/payable	0.0	0.0						
Debt securities	0.2	1.1	3.6	1.6	4.2	1,052	642	292
Housing + land	72.1	480.7	1548	63.8	260.2	65,445	39,921	42
Loans	-11.5	-77.0	-248	-13.9	-56.7	-14,258	-8,698	57
<b>Net housing / land wealth</b>	<b>60.5</b>	<b>403.7</b>	<b>1300</b>	<b>49.9</b>	<b>203.5</b>	<b>51,186</b>	<b>31,224</b>	<b>39</b>
TOTAL	100	667.0	2,148	100.0	409.3			
Total ex net housing	39.5	263.2	848	50.1	205.8			
Listed shares, mutual funds, insurance & pensions	20.0			24.1				
2020 GDP			322			21,803	13,300	68
Population			5.08			448		88
Farm/ rental adjustment			500					

RBNZ, Eurostat

### **Dominance of SME economy in New Zealand**

If private SMEs dominate the NZ economy and they are (presumably or at least initially) excluded from a taxonomy, does this make it less impactful in NZ?

- Data suggests the SME sector is actually larger in Europe. SMEs account for 28% of NZ employment / 28% of GDP (according to MFAT, and based on a 0-49 employee categorisation<sup>28</sup>); compared to 39% of employment and 38% of value added (0-49 employees, per Eurostat<sup>29</sup>).
- By count, 99% of business in Europe are <49 employees, compared to 97% in NZ.
- **The key point is that a comparably high share of SME activity did not prevent Europe from implementing a taxonomy.**

### **Dominance of bank financing in New Zealand**

Given the dominance of banks in financing the NZ economy, arguably the most relevant channel for a NZ taxonomy is through the banks.

- The same could also be said in Europe, however - only 10% of European SMEs' (up to 250 employees) external financing is from capital markets, and only 11% of businesses in Europe consider equity as a viable financing option while only 1% have used it.
- We have not found directly comparable data in NZ but we believe the overall picture (considering the household/SME activity data also) is that the EU economy is not wildly different from NZ in this respect.
- Europe is already working towards applying their taxonomy to banks. **So, we believe the argument in NZ should be the same as Europe – applying the taxonomy to bank products should complement / work alongside its application to investment products/ capital markets.**

### **Resistance to 'red tape' in New Zealand**

NZ ranks first globally in the World Bank's 2021 Ease of Doing Business rankings. EU-27 countries typically range from Denmark at 4, to Greece at 79, with Germany and France 22<sup>nd</sup> and 32<sup>nd</sup> respectively. At a high level this suggests business in Europe might be more receptive of a regulation like the taxonomy than in NZ. For detractors here the concept of a 1000+ page taxonomy is likely to challenge our 'light regulation' business mindset.

The most important rebuttal to this – and the argument that a taxonomy requires a government to 'pick winners'<sup>30</sup> - is that **a green taxonomy is essentially a disclosure tool. It does not itself restrict or forbid any activities.**

Firms are still free to engage in 'red' activities. These firms are already having to come up with strategies to manage interests and concerns from relevant stakeholders (such as customer and financiers) – so in this respect the introduction of a taxonomy in NZ would change, but not overhaul, the picture. **The 'market' would still determine the cost of finance for relevant companies – including presumably pools of capital willing to finance 'red' activities.**

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<sup>28</sup> Small Business Council NZ. (July 2019). Defining Small Business. *Recommendations of the New Zealand Small Business Council for the Minister of Small Business.*

<sup>29</sup> Eurostat. (November 25, 2019). Small and medium-sized enterprises: *an overview*. The EC refers to small business as 10-49 FTEs, micro less than 10, medium is 50-250. The 'Medium' category adds a further 17% of employees/ value add to the 38-39% above.

<sup>30</sup> Note that a part of the taxonomy will be used as a reference for certain EU-level government spending programs – for example the EU's significant Recovery and Resilience Facility uses the DNSH criteria, and thus seeks to exclude 'red' activities.

Similarly, there will be **new green technologies** that may be not captured appropriately by a taxonomy in real time – there is nothing stopping anyone investing in these, indeed if they are attractive enough presumably their taxonomy classification would be immaterial or even irrelevant to their cost of finance. Such technologies would be expected to be captured in periodic updates of a taxonomy’s technical criteria – something the market would be expected to anticipate in advance.

More specifically, recall that at least at the investment fund level (rather than for listed companies) the EU taxonomy is voluntary – funds can opt out and declare that they are not considering sustainability (‘Article 9’ funds – see Appendix 2). For NZ businesses, as in the EU, a size threshold would also be sensible, to reduce the cost to smaller enterprises (the EU uses EUR40mn turnover, 250 employees – see Appendix 2).

### **An interesting analogy from ANCAP safety ratings**

There are other disclosure tools that provide useful analogies – consider ANCAP safety ratings for cars, or less consequentially Energy Star ratings for appliances. In some ways these (especially energy ratings) are less complex than a taxonomy – but there are some common features:

- There is a clear public benefit to safer cars / more efficient appliances;
- consumers benefit from the disclosure regime:
  - i) reliable, clear and simple communication of what for most (but not all) consumers is an important aspect of the products;
  - ii) the ratings summarise information that, absent the mandated disclosure (energy / ANCAP rating) would be very hard for a consumer to assess;
- suppliers- car manufacturers and dealers - no doubt dispute the results on occasion – but overall are likely to support the scheme in ‘levelling the playing field’ and allowing efficient communication of key concepts;
- standards change and increase over time.

## Considerations for New Zealand asset management

### Potential portfolio impact in New Zealand

What change in portfolio composition might be needed in NZ as taxonomies are introduced?

We see this as quite difficult to assess at this stage. Even in Europe it is not yet clear to what extent portfolios will change, and when, under these regulations;

**Estimates are (from the EC) that existing taxonomy alignment will be very low for most funds; 0-5% (discussed in more detail in**

- What will benchmarks for funds be from a consumer perspective? Will it be 5%, 10%, 20% or 50% taxonomy alignment for a 'light green' fund (i.e. one claiming to incorporate ESG; Article 8 funds). What about a 'dark green' fund?
- How quickly will these benchmarks emerge? It is likely to take at least a year or two after initial fund level data publication next year – especially given data from underlying investee companies will come after.
- How quickly will companies adapt their activities and move up the 'traffic lights'?
- Although it is hard, there are approaches that could theoretically be used to investigate this question;
- A model portfolio for a typical NZ PIE or KiwiSaver fund could be created;
- Using data from a provider (these are discussed in
- 
- 
- 
- Activity examples in practice), its taxonomy alignment could be estimated;
- Future benchmarks e.g. 20% by 2025 could be assumed; along with assumptions on taxonomy progress by investee companies. There could be estimates from Europe for example of what taxonomy alignment might look like by 2030, should the goal of 50% emission reduction for example be achieved.  
**This is effectively back solving changes to theoretic portfolio composition to reach a future taxonomy alignment goal.**

All of this is clearly very speculative / assumption based – but may be an interesting exercise nonetheless.

### Product development – 2 growing to 3 dimensions?

It is early days and thus difficult to predict product development implications with confidence. Thus far we have not come across any detailed commentary/ research on EU or UK product development for example. In New Zealand, product positioning in the KiwiSaver market can be seen as largely 'two dimensional';

- Risk – most easily proxied by neutral equity allocation and as reflected industry standard product categories;  
Conservative (~20% neutral equity allocation), Moderate (~40%), Balanced (~65%), Growth (~80%) and Aggressive (~100%)
- Process: active vs passive.



In PIES (i.e. unit trusts), there is some more complexity (e.g. specific sector, regional, style, or return objective funds), however the overall concept of firstly a risk, and secondly an active/passive dimension arguably still applies.

**It seems sensible that over time a more sustainability focussed consumer will increasingly lead to a third dimension to this – how green is the product.**

- For some consumers, this is happening already through differing ESG credentials across the market (e.g. Pathfinder).
- But note at present, only 2% of investors in NZ choose KiwiSaver based on ESG as a primary consideration, according to Mindful Money’s surveying. Most clients care about ESG, but not at present as the primary consideration. This will of course continue to evolve over time – in discussing the drivers for green finance Singapore’s MAS references analysis arguing that “35% of Asia’s wealth will be in the hands of millennials in the next five to seven years”<sup>31</sup>;
- In terms of sustainability the market could conceivably segment to *Impact, good ESG, moderate ESG, no ESG* (or something similar; fewer or more buckets). Applying a taxonomy lens that translates to several ‘buckets’ with a range (in %) of taxonomy portfolio alignment. Even in Europe market standards for what ‘good’ taxonomy alignment is are yet to emerge, so this will take time.

There is potential for sustainability outcomes to be linked to fund fees; effectively a **sustainability performance fee**. This would underline the importance of reaching targets (e.g. higher % taxonomy alignment for a fund in future years).

## Requisite Financial products

In funds management, traditional financial products (e.g. shares, bonds) seem largely compatible with the rollout of a taxonomy in NZ. Some potential developments that would further assist / accelerate sustainable financing flows are:

- **ETFs targeting taxonomy alignment** (e.g. S&P500 or NZSE50 20%+ or 50%+ taxonomy aligned). We believe these will evolve naturally globally given existing depth and proliferation in the ETF market. These would assist NZ managers to lift taxonomy alignment in KiwiSaver and other funds;
- **Deeper carbon markets** – this will not affect taxonomy alignment per se but will be useful as managers look to potentially offset portfolio level carbon;
- **Introducing Taxonomy targets to sustainability-linked bonds** - e.g. coupon steps up by 50bps 3 years into a 7 year bond if company does not achieve ex- ante goals for taxonomy alignment on given KPI. The higher the coupon step-up, the more meaningful the commitment and impact on the issuer;
- **Similarly, sustainability linked institutional / corporate loans referencing the taxonomy;**
- Voluntary adoption of the EU’s classification criteria here in NZ could allow the use of such a structure (either in loans or bonds) in a short space of time;
- Introducing Taxonomy alignment targets to corporate management incentives

Another critical area for thinking about necessary taxonomy-related product innovation in NZ is in banking – for example the work established by The Aotearoa Circle on SAFI (Sustainable Agriculture Finance Initiative), which Toitū Tahua now hosts. The dominance of mortgages as a product in our banking sector

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<sup>31</sup> Mr Ravi Menon, Monetary Authority of Singapore. (March 9, 2021). The Future of Capital is Green” – Key note address

also clearly provides scope to attempt to innovate there (mortgages linked to new build efficiency) - and potentially set global examples.

# The global state of play

## Taxonomies in other regions

There are a number of countries where a taxonomy is already legislated and in use. At COP 26 it was noted that there are over 30 ‘serious’ ones at various stages of development<sup>32</sup>.

In general, most of these are currently focussed on classifications of green bonds – although the picture is changing quickly. That is, at present many of these taxonomies are a classification system that determine whether a given bond can be classified as a ‘green bond’ or not .

As shown in the table below, Russia, China and Japan for example all have operational taxonomies to this effect.

The EU, followed by the UK, are leading the way with more integrated application of their taxonomies across company reporting and investment products. This clearly provides much more scope to influence transition-enabling investment flows than programs focussed on green bonds. Closer to home, ASEAN’s taxonomy is also very well progressed and includes some interesting nuances more reflective of economies in its member states.

## Summary of green taxonomy status in notable countries / regions

Where	Status	Timeframe (indicative)
China	Mainly (at present) used for green bonds	In use since 2015
UK	Accelerated development underway; ambition to be “the best place in the world for green and sustainable investment”	Implementation from 2023-25
ASEAN	Two-tier taxonomy being deployed, with basic and higher thresholds. National regulators governing exact requirements for each member state.	Initial framework in use from Nov 2021
USA	No clear plan for a taxonomy at present; some investigation underway by regulators	N / A
Singapore	Industry led taxonomy in co-ordination with central bank; first draft released Jan 2021	
Australia	Potential development of taxonomy by finance industry; no government program at present	Industry targeting 2021-22
Canada	‘Transition’ taxonomy being developed	First draft due shortly
Japan	Mainly (at present) used for green bonds	In use since 2017
Russia	Mainly for green bonds and loans	Introduced in Sep 2021
EU	Wide-ranging green taxonomy already being introduced	Implementation from 2022-24
New Zealand	Voluntary standards for agriculture in use (SAFI - Sustainable Agriculture Finance Initiative – developed by industry in conjunction with government). No current plan for broader green taxonomy.	SAFI phase one guidance released July 2021

<sup>32</sup> David Woods, Toitū Tahua: Centre for Sustainable Finance. (November 7, 2021). CO26 Update from David Woods.

Note that there is also a voluntary certification scheme for green bonds – the Climate Bonds Standard – that is widely used in capital markets globally. This is overseen by Climate Bonds Initiative, a large not-for-profit working to develop sustainability in the bond market. It has developed a taxonomy / classification system covering a number of sectors, and using a threshold consistent with the Paris agreement’s ‘well below 2 degree’ warming target). Over USD200bn in bonds have now been certified; in NZ, for example, Contact’s green bond programme has been using this standard since its inception in 2017.

ISO (International Organization for Standardization) has also developed a taxonomy for evaluating environmental performance of green debt instruments<sup>33</sup>.

## ASEAN<sup>34</sup> taxonomy

**There has been significant progress towards operational taxonomies in South East Asia both at a national and regional level.** Singapore (detailed below) and Malaysia (first draft released April 2021) are noteworthy for well progressed domestic frameworks.

At the ASEAN level a taxonomy is being developed that will work alongside taxonomies at individual member states. The first version was released in November<sup>35</sup>. It is meant to work “as a map to help guide capital towards activities that can promote the transition of activities in the real economy onto a more sustainable footing”. Given the varied state of economic development across the region, a ‘one size fits all’ approach was considered inappropriate.

Instead, the ASEAN taxonomy uses a two-tier architecture;

- a *Foundation Framework* – applicable to member states and allowing a *qualitative* assessment of activities
- the *Plus Standard* with metrics and thresholds to further qualify and benchmark eligible green activities and investments. For each activity it “starts with less ambitious thresholds to facilitate early adoption and leading up to more ambitious “gold standard” thresholds that reference science-based pathways”.

Akin to the EU and UK programs, its initial focus is on climate change, ahead of moving on to other sustainability aspects.

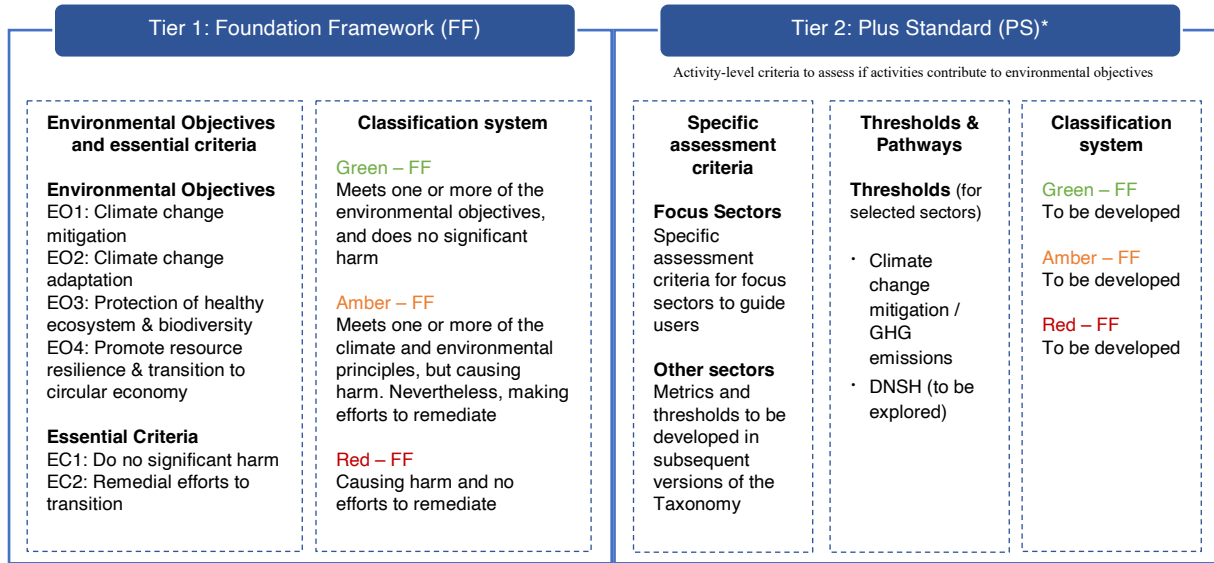
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<sup>33</sup> ISO. (September, 2021). Environmental Performance Evaluation – Green debt instruments – Part 1: Process for green bonds.

<sup>34</sup> Association of Southeast Asian Nations; Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam.

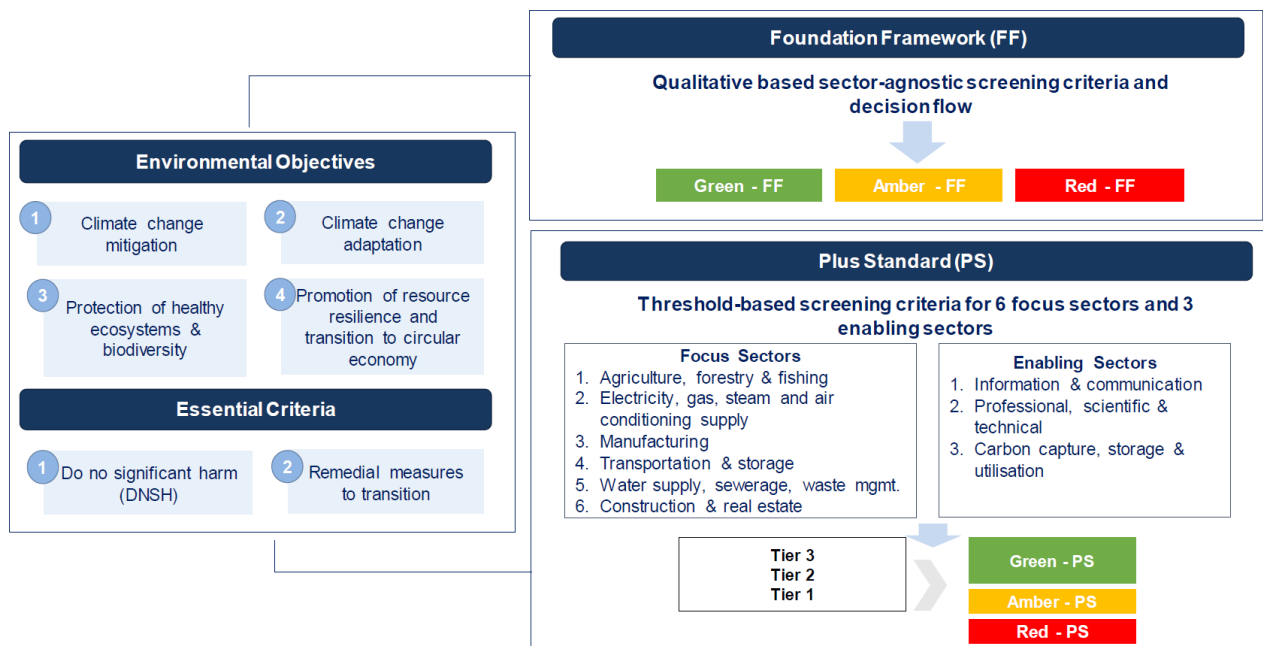
<sup>35</sup> ASEAN Taxonomy Board. (November 2021). ASEAN Taxonomy for Sustainable Finance: *Version 1*.

ASEAN taxonomy two-tier approach<sup>36</sup>



As shown below, the Plus Standard initially maps criteria for six focus sectors. It uses a traffic light system, and a DNSH threshold also applies. Detailed criteria have not yet been determined - a key point to address is transition energy sources, especially given the less mature economies in several member states. Version one of the taxonomy does suggest the potential for nuclear and coal to avoid a 'red' categorisation at least initially, provided certain controls are in place (e.g. carbon capture, utilisation and storage / nuclear waste management).

Overview of classifications in ASEAN taxonomy<sup>36</sup>



<sup>36</sup> ASEAN Taxonomy Board. (November 2021). ASEAN Taxonomy for Sustainable Finance: *Version 1*.

**The program is intended to help a range of stakeholders from large corporates to SMEs** (likely to focus on the Foundation Framework) better understand their sustainability decisions, and recognising the state of knowledge across many businesses in the region on sustainability is low. It seems likely to be coordinated with disclosure for investments funds and products over time, however this does not appear to be an initial focus. This contrasts somewhat the EU program which focuses on investors as end-users and through improved fund disclosure seeks to combat greenwashing. Of note, at present the ASEAN taxonomy does not include a minimum safeguard for human rights protection – this appears to be set to be addressed at the national level.

## Singapore

Singapore's central bank (Monetary Authority of Singapore; or MAS) has convened The Green Finance Industry Taskforce (GFIT), comprising representatives from financial institutions, corporates, non-governmental organisations, and financial industry associations. Its mandate is to “is to help accelerate the development of green finance through four key initiatives”, one of which is the development of a taxonomy. Work is well progressed with the first draft for consultation released in January 2021. Allen and Overy have described it as **aligned ‘to a large extent’ with the EU’s program**<sup>37</sup>.

In a recent speech at COP 26 the head of MAS Ravi Menon summarised the plan as “it adopts a “traffic light” system that helps market participants identify activities that are “green”, “yellow” (or transition) and “red”, with the intent of reaching net zero as soon as possible. The calibration of thresholds is important, considering the feasibility and availability of alternative technologies in Singapore and the region. The thresholds will need to be recalibrated at regular intervals to keep pace with technological innovations”. He noted that a **single global taxonomy was unlikely and instead (like the UK has done) emphasised the need for interoperability and comparability across different global frameworks**<sup>38</sup>.

## China

China has used a classification scheme for green bonds since 2015 – the “Green Bond Endorsed Project Catalogue”. Reference’s to China’s ‘green taxonomy’ are typically to this framework. It takes a multi-dimensional approach defining as green projects that consider environmental benefits from “GHG emission reduction, pollution reduction, resource conservation, ecological protection”.

China is often seen progressive in green finance and it has developed a large green bond market – in 2019 it was second to the US in green bond issuance. Reflecting some weaker standards however, at least in the past, the OECD notes that in 2019 only 56% of Chinese bonds certified as Green satisfied international definitions. Over the past two years standards have improved with fossil fuels now excluded from its taxonomy (previously there was space for oil and coal) – contrasting the EU, where gas can be included.

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<sup>37</sup> Allen & Overy. (February 5, 2021). Singapore consults on a taxonomy for the financing of environmentally sustainable activities.

<sup>38</sup> Monetary Authority of Singapore. (November 4, 2021). An Effective and Inclusive Transition to Net Zero – keynote speech by Mr Ravi Menon at COP26

## Basic principles of China's 'Green taxonomy' (Green Bond Endorsed Project Catalogue)

The following text from the Catalogue describes the basic principles to which it adheres:

- “Conforming to national conditions: focusing on improving the ecological environment and easing resource pressure, and following the lead of national industrial policy at the current stage.
- Highlighting environmental benefits: supporting projects with marked environmental benefits and positive spill over effects.
- Being simple and clear: taking into account the fact that most of the capital market practitioners are non-environmental professionals, and thus employing definition and classification method that is easy to follow and operate.
- Making continuous adjustment: timely updating the Catalogue and according to technological advancement, policy adjustment, standard updates and changes in resource and environmental conditions.
- In line with international practice: taking international standards and practices as reference to develop domestic definition and classification method, in order to facilitate international cooperation in green finance”

OECD

In addition, China's has a “Guiding catalogue for the green industry”, introduced in 2016 and updated in 2019. This is fairly narrow in scope and lists green activities across six sectors (Manufacture of energy efficient equipment, Clean production industry, Clean energy industry, Industry of ecology and environment, Green upgrade of infrastructure, Green services). At first glance it appears therefore more of a ‘dark green’ classification threshold. The OECD notes it contains no metrics or thresholds – much less detailed than the EU's system therefore.

Finally, for lending, the **China Banking Regulatory Commission began issuing green credit guidelines around a decade ago. This includes performance indicators and reporting forms. As of 2017 9% of lending was classified as green;** the value of these loans is circa 10x larger than total Chinese green bonds outstanding. Note fossil fuels could not qualify, in contrast to China's green bond classification.

In recent years there have been efforts to harmonise sustainable finance definitions in China using the catalogue as the key standard, after earlier criticism of the lack of co-ordination between the various standards.

## United Kingdom

The UK Treasury in October 2021 released “Greening Finance: A Roadmap to Sustainable Investing”, which includes a section on how the UK will develop its own Green Taxonomy.

Deloitte's analysis of this paper notes **a very high degree of alignment between the UK and EU taxonomies;** “The indications are the UK will align with the Brussels-to-Beijing approach. The UK Roadmap [makes] frequent references to consistency, comparability and what it calls “international interoperability”...We compared the EU and the UK taxonomies across ten major dimensions and found full alignment on three dimensions, significant alignment on five, and two where it's not yet clear.”<sup>39</sup>.

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<sup>39</sup> Deloitte. (November 3, 2021). COP26 and the UK's Green Taxonomy: the virtues of comparability.

As shown below the environmental objectives are identical – a clear indication of how much the UK has drawn from the EU’s existing work.

Environmental objectives for EU and UK taxonomies<sup>40</sup>

EU Taxonomy Objectives (environmental)	UK Green Taxonomy Objectives (environmental)
<ul style="list-style-type: none"> <li>· Climate change mitigation</li> <li>· Climate change adaptation</li> <li>· Sustainable use and protection of water and marine resources</li> <li>· Transition to a circular economy</li> <li>· Pollution prevention and control</li> <li>· Protection and restoration of biodiversity and ecosystems</li> </ul>	<ul style="list-style-type: none"> <li>· Climate change mitigation</li> <li>· Climate change adaptation</li> <li>· Sustainable use and protection of water and marine resources</li> <li>· Transition to a circular economy</li> <li>· Pollution prevention and control</li> <li>· Protection and restoration of biodiversity and ecosystems</li> </ul>

Like the EU, the **UK will also apply a DNSH threshold** (that is, an activity must make a ‘substantial contribution’ to one of the above objectives, and DNSH to the others); **while also applying a set of “minimum standards for doing business, constituting alignment with the OECD Guidelines for Multinational Enterprises, and the UN Guiding Principles on Business and Human Rights”**.

Importantly the UK taxonomy will apply across business, the financial sector and investment products – thus it is a deeper program than those mentioned above oriented largely at green bonds. Companies will be required to report the proportion of revenue/ capex in taxonomy-aligned activities, and investments funds in turn will report their proportional taxonomy alignment. The UK Treasury notes that “This will be accompanied by a consumer-facing label developed by the FCA so that consumers can make informed investment decisions that take sustainability into account”<sup>41</sup>.

### UK government’s aims for its taxonomy

- i) **Create clarity and consistency for investors:** Investors will be able to easily compare the environmental performance and impact of companies and investment funds to inform their financial decisions.
- ii) **Improve understanding of companies’ environmental impact:** Taxonomy disclosures will facilitate and understanding of companies’ contribution to environmental sustainability.
- iii) **Provide a reference point for companies:** The Taxonomy will provide companies with an informative performance target. For example, they can also, on the voluntary basis, use the Taxonomy to develop and communicate their net zero transition and capital investment plans.

<sup>40</sup> Deloitte. (November 3, 2021). COP26 and the UK’s Green Taxonomy: the virtues of comparability.

<sup>41</sup> UK Treasury. (October 18, 2021). Green Finance: A Roadmap to Sustainable Investing



## Revenue reporting example: UK framework identical to EU's<sup>42</sup>

What economic activities does the company do?	Generating energy from Wind Power	Generating energy from Coal	Manufacture of Cement	
Is there a TSC for this activity?	✓	✗	✓	
Example portfolio of company's existing projects	Wind farm	Coal power plant	Best in class cement plants	Other cement plants
Does the activity meet TSC thresholds?	✓		✓	✗
Does the activity meet the Do No Significant Harm criteria?	✓		✓	
Does the company meet the minimum safeguards?	✓			
Revenue from these activities	40%	10%	20%	30%
	60% of company revenue taxonomy aligned			

In terms of timing, consultation is scheduled for Q1, 22 for the two climate related objectives (mitigation and adaptation), with the other four to follow<sup>43</sup>. Eventual Taxonomy disclosure for corporates was seen as 1-2 years away (relative to the UK's October 2021 report), and 2-3 years away for larger (>GBP5bn) investment funds, with smaller funds to follow. Overall the timeline is, according to Deloitte, “**generally consistent with the EU's timelines, albeit slightly longer**”, thus giving UK regulators “full sight of the EU's approach before considering their own”. Full implementation is seen by 2025.

## United States

While there has been some noise at the fringes, there are currently no evident plans for an EU-style taxonomy in the US, and enthusiasm for the concept from US regulators appears mixed. Looking more closely at the detail, in the US finance and corporate/ reporting regulation is conducted by a variety of governmental agencies (the Treasury, SEC, Federal Reserve, CFTC, etc). Within these, there has been some discussion of the potential need for a taxonomy in the US – the CFTC in 2020 recommended the development of “U.S.-appropriate standardized and consistent classification systems or taxonomies for physical and transition risks, exposure, sensitivity, vulnerability, adaptation, and resilience, spanning asset classes and sectors”<sup>44</sup>. The CFTC had some hesitation however in noting that “explicitly setting thresholds poses challenges, particularly given the diversity of the U.S. economy and the context of the U.S. regulatory structure”. Notwithstanding these, **it recommended the establishment of a “Standards Developing Organization (SDO) composed of public and private sector members” to develop this classification / taxonomy guidance**. Following the report, PwC noted that it saw the development of a US taxonomy as likely<sup>45</sup>.

<sup>42</sup> UK Treasury. (October 18, 2021). Green Finance: A Roadmap to Sustainable Investing

<sup>43</sup> Green Finance Institute. Green Technical Advisory Group (GTAG) to provide independent advice on market, regulatory and scientific considerations for developing and implementing the Taxonomy, Chaired by the Green Finance Institute.

<sup>44</sup> CFTC. (September 2020). Managing Climate Risk in the US Financial System

<sup>45</sup> Reuters. (July 2021). U.S. regulators seen developing 'green taxonomy' to provide guidance to financial firms.

Following this, the CFTC launched in March 2021 a new “Climate Risk Unit”. Its mandate includes “Increased participation in domestic and international fora aimed at building consensus for consistent standards, taxonomies, disclosures, and practices across derivatives products and markets, as well as related clarity on regulatory, capital, and accounting standards”. The focus on derivative markets – which is of course consistent with the CFTC’s broader role in US market regulation – **suggests a narrow scope for this taxonomy work** (more limited even than the green bond oriented taxonomies mentioned above). Beyond that, there appears to have been little concrete progress towards a taxonomy in the US. President Biden’s March 2021 *Executive Order on Climate-related financial risk* requested, among a wide variety of initiatives, that the US Treasury to report back on “improvements to climate-related disclosures and other sources of data”. This report was released in October and did not contain any plan for a US taxonomy<sup>46</sup> – indeed there was very limited discussion of taxonomies generally<sup>47</sup>.

Given the complexity of US financial regulation, there is potentially work ongoing in other agencies, however there appears nothing to date that has generated any mention in the international financial press (in contrast to the EU taxonomy, which is mentioned almost daily).

Taking a broader view, while the Biden administration is making some progress, sustainable finance regulation in the US appears to have some huge gaps to close versus Europe. As one example, the Department of Labour is still trying to get approval for pension funds to even consider sustainability factors in their investments and proxy voting, following a 2020 law that effectively prohibited the use of ESG funds pension plans (401(k) plans). This law is expected to be overturned over 2022.

## Australia

There is work underway in Australia towards a taxonomy, although it appears to be in its fairly early stages.

The Council of Financial Regulators (CFR) in 2017 set up a *Working Group on Financial Implications of Climate Change*. One of its three priorities for 2021/22 is to “examine the implications of emerging sustainable finance taxonomies, including for investment flows, and consider possible Australian approaches to these developments”. Within this the CFR will monitor “the risk that a dominant [international] taxonomy emerges that is not well suited to Australia’s need to finance the transition to lower carbon emissions” and indeed the CFRs agencies will seek to “influence” common global taxonomies in this respect.

Of note a recent RBA speech gave a mixed albeit ultimately supportive assessment of taxonomies; “While we may think that taxonomies in place elsewhere in the world are not appropriate for the Australian situation, we need a realistic alternative. Not having a taxonomy won’t beat an existing bad one”<sup>48</sup>.

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<sup>46</sup> Schroders. (January 6, 2022). The ESG regulation race is on.

<sup>47</sup> The only passage of note in the 133 pages was: “Some observers have suggested greater disclosure or the use of taxonomies or other standardized classifications of assets, while others have suggested more granular data that allows ESG providers to offer more tailored products”.

“FSOC [Financial Stability Oversight Council] Report on Climate-Related Financial Risk”, October 2021.

<sup>48</sup> Reserve Bank of Australia. (October 14, 2021). Climate Risks and the Australian Financial System: speech by Deputy Governor (and Chair of the CFR working group).

The Australian Sustainable Finance Initiative (ASFI)<sup>49</sup> – a similar body to Toitū Tahua - recommended in its November 2020 roadmap, that Australia implements a sustainable finance taxonomy, and joins the IPSF to help facilitate this. To date Australia has not joined. ASFI is working towards introducing an industry-led taxonomy over 2021/22. Note there is some co-ordination with regulators – ASFI’s steering committee has both ASIC (Australian Securities and Investments Commission) and APRA (Australian Prudential Regulation Authority) as observers.

## Other taxonomies – Russia, Canada, etc.

Russia passed its own green taxonomy into regulation in September 2021 – reasonably quickly given work on it appears to have started only in Q42020. It is sector-specific in high emission areas: waste management, energy, construction, industry, transport, water supply, biodiversity, and agriculture. The energy criteria include science-based thresholds for electricity generation, based on the recommendations of the Technical Expert Group for the EU’s Taxonomy, including the 100g CO<sub>2</sub>/kWh threshold for electricity generation from fossil gas. It was designed to align with key global standards – specifically the Climate Bonds Initiative<sup>50</sup> which notes it is “broadly in line with the Climate Bonds Taxonomy and with the ‘substantial contribution’ components of the EU Taxonomy”<sup>51</sup>.

In Canada, the Canadian Standards Association, **a non-profit industry body is developing a ‘transition taxonomy’** (funded by four banks and 2 pension funds). This seeks to provide **criteria and methodologies assessing the transition paths of companies operating in traditionally high emission sectors**. The first draft was expected by year-end 2021 but has been delayed. It has been criticised for its expected support of fossil fuels.

Japan’s Ministry of the Environment began using a green bond classification scheme in 2017. France has used a GreenFin label for retail investments since 2015 while the Netherlands’ Green Funds Scheme began back in 1995. South Africa is developing a green and also a social taxonomy.

## Global harmonisation of taxonomies

European companies operating globally are very likely to apply the EU Taxonomy lens to their global operations. Similarly EU investors will be trying to assess whether international investments are taxonomy-aligned. The degree of focus and urgency around this remains to be seen – it will obviously differ by asset manager and will evolve as consumer understanding improves, and market pressure around taxonomy alignment increases.

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<sup>49</sup> Australian Sustainable Finance Initiative

<sup>50</sup> Climate Bonds Initiative is a large not-for-profit working to develop sustainability in the bond market; it runs a certification scheme / taxonomy for green bonds with over USD200bn in bonds now certified (versus a threshold consistent with the Paris agreement’s well below 2 degree warming target).

<sup>51</sup> Climate Bonds Initiative. (2021). Russian Federation adopts green taxonomy: Matches 100g Co<sub>2</sub> gas-power threshold in EU Parliament’s approved Act

## International Platform on Sustainable Finance

As mentioned, over 30 taxonomies are being developed globally, providing scope for material differences in standards.

With a view to co-ordinating global standards, the EU in late 2019 convened the International Platform on Sustainable Finance (IPSF) to “encourage dialogue and, where appropriate, coordination on development of taxonomies”. There are 18 members; of note the US and Australia are not involved.

IPSF members are: Argentina, Canada, Chile, China, European Union, Hong Kong SAR, India, Indonesia, Japan, Kenya, Malaysia, Morocco, New Zealand, Norway, Senegal, Singapore, Switzerland and the United Kingdom.

Together, this equates to: 55% of global GHG emissions, 55% of global GDP and 50% of the world population.

As part of the IPSF, there is a Taxonomy Working Group co-chaired by the EU and China. In November 2021 it released a detailed report “Common Ground Taxonomy – Climate Change Mitigation”<sup>52</sup>. It describes this Common Ground Taxonomy (CGT) as “a milestone work resulting from an in-depth comparison exercise that puts forward areas of commonality and differences between the EU and China’s green taxonomies”. Schroders describes the CGT as “not a taxonomy per se but rather a tool that effectively compares ...and translates the one to the other...[it] is still under development but, if it works, it could be a very useful tool for those who invest globally”<sup>53</sup>.

It is intended partly to assist other jurisdictions in potential taxonomy development. The CGT is also “designed to be inclusive and flexible so as to incorporate new jurisdictions which develop taxonomies over time”.

What is the Common Ground Taxonomy (CGT)?<sup>52</sup>

The Common Ground Taxonomy is...	The Common Ground Taxonomy is not...
An analysis on approaches of the EU taxonomy and China taxonomy, and the methodology for comparing and identifying commonalities and differences between some features of the two taxonomies	A legal documentation by the EU and China which entails requirement/obligation for either jurisdiction to change their taxonomy
An evolving tool that may help different actors to understand the types of activities that could be covered under the respective taxonomies within the scope of the comparison exercise	A single taxonomy or exclusive definition of environmentally sustainable economic activities covering all environmental objectives such as biodiversity, pollution prevention, etc.
A technical document for voluntary reference by interested parties within the limits of the scope of the comparison exercise	Covering all eligibility features or all activities in the EY and China taxonomies as explained in the instruction report.
An analytical tool or reference for other jurisdictions to consider when developing their own taxonomies	A proposal for international standards or legal document that imposes any global standard on other jurisdictions.

<sup>52</sup> International Platform on Sustainable Finance. Common Ground Taxonomy – Climate Change Mitigation. Instruction Report.

<sup>53</sup> Schroders. (January 6, 2022). The ESG regulation race is on.

## OECD's 2020 analysis – EU's taxonomy stands out

The OECD – an observer to the IPSF - has produced a useful albeit now slightly dated paper on “Developing Sustainable Finance Definitions and Taxonomies”<sup>54</sup>. This includes a discussion of design considerations for a national taxonomy – what to do about transition activities, unsustainable taxonomies, social taxonomies. It notes the need to consider a systems approach – “an activity cannot be considered sustainable independent of the wider system in which it operates”, and multiple emissions pathways. The OECD noted that the EU taxonomy is “unique in the level of detail in taxonomy compliance requirements” and is the only one (at that time) that links multiple environmental objectives together through the DNSH threshold. There is also an analysis of similarities and differences between five national taxonomies.

## Other sources

The EU's “Final report of the Technical Expert Group on Sustainable Finance” has some general discussion on international harmonisation and presents a list of very general concepts to consider for global taxonomies<sup>55</sup>. We believe this is too simple to be of any material use for NZ, and obviously discussion has progressed significantly in the 20 months since this was published.

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<sup>54</sup> OECD (2020). Developing Sustainable Finance Definitions and Taxonomies, Green Finance and Investment. OECD Publishing, Paris.

<sup>55</sup> EU Technical Expert Group on Sustainable Finance (2020). Taxonomy: Final report of the Technical Expert Group on Sustainable Finance. Pg. 53

## Appendices

### Appendix 1 – EU Taxonomy basics

Many readers will already be familiar with the EU and/or other green taxonomies under consideration. This section provides some basics. There are many summaries available (and not much benefit to creating another) - the below from the EU Commission's FAQ on the taxonomy<sup>56</sup> provides a good overview:

The EU Taxonomy is a **green classification system** that translates the EU's climate environmental objectives into criteria for specific economic activities for investment purposes.

It recognises as green, or 'environmentally sustainable', economic activities that make a **substantial** contribution to at least one of the EU's climate and environmental objectives, while at the same time not significantly harming any of these objectives and meeting minimum social safeguards.

The Taxonomy Delegated Acts will establish and maintain clear criteria for activities to define what it means to make a substantial contribution and what it means to do no significant harm.

It is a **transparency tool** that will introduce mandatory disclosure obligations on some companies and investors, requiring them to disclose their share of Taxonomy-aligned activities. This disclosure of the proportion of Taxonomy-aligned activities will allow for the comparison of companies and investment portfolios. In addition, it can guide market participants in their investment decisions.

Companies, if they wish, can reliably use the EU Taxonomy to plan their climate and environmental transition and raise finance for this transition. Financial companies, if they wish, can use the EU Taxonomy to design credible green financial products.

Nevertheless, the EU Taxonomy is not a mandatory list of economic activities for investors to invest in. Nor does it set mandatory requirements on environmental performance for companies or for financial products. Investors are free to choose what to invest in. However, it is expected that over time, the EY Taxonomy will be an enabler of change and encourage a transition towards sustainability.

Economic activities that are not recognised by the EU Taxonomy Delegated Acts as substantially contributing to one of the EU's climate and environmental objectives are not necessarily environmentally harmful or sustainable. And not all activities that can make a substantial contribution to the environmental objectives are yet part of the EU Taxonomy Delegated Acts. Delegated acts will be living documents that will be added to over time and updated as necessary

### Appendix 2 – Other disclosure regulation – NFRD/ CSRD, SFDR

#### Interaction of SFDR, NFRD/CSRD and Taxonomy Regulation (TR)

The key high level takeaway is that SFDR, CSRD and the Taxonomy are all key elements of the EU's broader **Sustainable Finance Action plan** and specifically its goals on **improving transparency**. Companies that fall under the scope of NFRD (expected to become CSRD) need to also satisfy disclosures requirements of the Taxonomy Regulation (TR). Changes to NFRD /CSRD will automatically impact TR. In November the European Supervisory Authorities (ESAs) released their 'Final Report on Draft Regulatory Technical Standards' (final draft RTS). **This final draft RTS aims to create a "single rulebook" for sustainability-related disclosures for SFDR pre-contractual and periodic product disclosures including Taxonomy-related product disclosures.** <sup>57</sup>

<sup>56</sup> European Commission: "FAQ: What is the EU Taxonomy and how will it work in practice"

<sup>57</sup> European Supervisory Authorities. (October 22, 2021). Final Report on draft Regulatory Technical Standards.

## Sustainable Finance Disclosure Regulation (SFDR)

A key part of the EU’s action plan is Sustainable Finance Disclosure Regulation (SFDR) which came into effect in March 2021. For asset managers it requires funds to be classified into three groups:

- i) Article 6 funds: those that do not promote their ESG characteristics / do not integrate ESG analysis in investment selection.
- ii) Article 8 Funds: ‘Light green’: “Where a financial product promotes, among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices”. Commentators have suggested Article 8 will become the standard for most funds in the EU.
- iii) Article 9 Funds: ‘Dark green’: “Where a financial product has sustainable investment as its objective and an index has been designated as a reference benchmark.”

Taxonomy disclosure is required across Article 8 and 9 products. Article 6 funds effectively opt out from making these disclosures as they are making no ESG claims about their process.

### Sustainable Finance Disclosure Regulation (SFDR) Timeline<sup>58</sup>



SFDR includes a requirement for “Adverse Sustainability Impacts Statement” - from June 2021.

- This is part of the Principal Adverse Impacts (PAI) regime
- It operates on an “opt in” or “opt out” basis – e.g. an asset manager can positively opt to consider the principal adverse impacts of its investment decisions on sustainability factors, or it can opt out with an appropriate disclosure. – for example: “The investments underlying this financial product do not take into account the EU criteria for environmentally sustainable economic activities”.

Specifically the Adverse Sustainability Impacts Statement requires disclosure on a fixed template covering 7 areas:

- i) Summary
- ii) Details on the Adverse Sustainability Impact Statement
- iii) Description of policies to assess principal adverse sustainability impacts
- iv) Description of actions to address principal adverse sustainability impacts
- v) Engagement policies
- vi) References to international standards
- vii) Historical comparison

This will be policed using a system of 64 adverse impact indicators, of which 18 will be mandatory to report, and 46 will be voluntary. The compulsory factors range from carbon emissions, fossil fuel exposure and waste levels (E) to gender diversity and due diligence over human rights (S) and a company’s record on exposure to corruption, bribery or other scandals (G).

<sup>58</sup> BIQH SFDR Team. (August 25, 2021). Sustainable Finance Disclosure Regulation (SFDR) Timelines.

Note there have been delays with the publication of the prescriptive details underling the SFDR – that is the regulatory technical standards (‘RTS’). This has meant that according to Robeco “The financial industry first needed to classify its funds before the actual technical standards of what that classification would entail in terms of actual ESG restrictions were available.”

As of July a six month delay to the introduction of RTS means they will now be introduced in July 2022. Allen and Overy noted in September that “It is not yet clear if this will mean a delay of six months to all the other dates relevant to SFDR and the Taxonomy Regulation; so far, we are taking a conservative approach and assuming that only the start date is affected”.<sup>59 60 61</sup>

## Corporate Sustainability Reporting Directive (CSRD)

**Requirements for corporates were first addressed in 2018 in the Non-Financial Reporting Directive [NFRD] which has subsequently been revised and expanded in the Corporate Sustainability Reporting Directive [CSRD; not yet passed by the EU parliament as at December 2021].**

As a Directive (i.e. NFRD) this means the EU has passed legislative acts that set out goals, but each member state is still allowed its own set of regulations to comply.

Key points on CSRD:

- Launched April 2021
- Currently under negotiation by European Parliament and Council – EC notes that “if they reach agreement in the first half of 2022, companies would apply the standards for the first time to reports published in 2024, covering financial year 2023.”
- The CSRD aims to ensure alignment specifically with the SFDR and taxonomy regulation and to reduce complexity and potential duplicative reporting requirements. It ensures that companies report the information that investors and FMPs (financial market participants) need.
- CSRD covers all European listed companies, and large non-listed companies (Assets > € 20mIn, Revenues > € 40mIn, Employees > 250; detailed below).
- CSRD will broaden the current NFRD scope by at least four times and over 50,000 companies will be mandated under this directive; over 75% of company turnover in the EU.
- Companies must prepare statements and reports in XHTML format in order to tag their sustainability information according to a specified digital categorisation system
- Audit requirement - companies within scope will be required to seek limited assurance over their reported sustainability information - which may move towards a reasonable assurance requirement at a later stage (PwC).
- Sign off / responsibility - Administrative, management and supervisory bodies will be required to actively and demonstrably bear collective responsibility for sustainability reporting. The balance sheet oath, which until now only referred to financial reporting, is expected to be extended to the reporting of sustainability information. (PwC)

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<sup>59</sup> Kenneth Robertson, Robeco. (February 17, 2021). How regulation will enhance sustainable investing in 2021.

<sup>60</sup> BIQH. Sustainable Finance Disclosure Regulation (SFDR): The Adverse Sustainability Impacts Statement)

<sup>61</sup> Allen and Overy. (September 2021). SFDR and taxonomy regulation deadlines – *What EU asset managers need to know*



In terms of scope, KPMG offers the following summary<sup>62</sup>:

	<b>Current EU Directive 2014/95/EU</b>	<b>Corporate Sustainability Reporting Directive</b>
What is the scope of the reporting requirements?	<ul style="list-style-type: none"> <li>• Environmental protection</li> <li>• Social responsibility and treatment of employees</li> <li>• Respect for human rights</li> <li>• Anti-corruption and bribery</li> <li>• Diversity on company boards (in terms of age, gender, educational and professional background)</li> </ul>	<ul style="list-style-type: none"> <li>• Double materiality concept: Sustainability risk (including climate change) affecting the company + Companies' impact on society and environment</li> <li>• Process to select material topics for stakeholders</li> <li>• More forward looking information, including targets and progress thereon</li> <li>• Disclose information relating to intangibles (social, human and intellectual capital)</li> <li>• Reporting in line with Sustainable Finance Disclosure Regulation (SFDR) and the EU Taxonomy Regulation</li> </ul>
To which companies will it be applicable?	<p>Large public interest entities with &gt; 500 employees</p> <p>Public interest entities are:</p> <ul style="list-style-type: none"> <li>• Listed companies</li> <li>• Banks and Insurance companies</li> </ul>	<p>All large companies meeting at least 2 out of 3 criteria:</p> <ul style="list-style-type: none"> <li>&gt; 250 employees and/or</li> <li>&gt; €40M Turnover and/or</li> <li>&gt; €20M Total Assets</li> <li>• Listed companies</li> </ul> <p><i>Note: small and medium listed companies get an extra 3 years to comply.</i></p>

### Financial advisors - MIFID II changes

Of note under upcoming changes to MIFID II - **financial advisors will be required to ensure customers sustainability preferences are explicitly identified and understood as part of the financial advice process..**

### Other Green labels and standards

The EU Commission's FAQ on the taxonomy provides the following overview covering how taxonomy alignment overlaps with other green labelling regulation:

Green standards and labels:

The Taxonomy Regulation requires Member States and the EY to use the EU Taxonomy as the basis of any EU or national (public) labels for green corporate bonds or financial products that fall under the scope of the SFDR. The EU Taxonomy therefore provides a good basis for the development of further sustainable finance tools, including the EU Ecolabel for Retail Financial Products and future EY standards for green bonds (all under development) as well as green mortgages.

Ongoing EU policy initiatives will link standards and labels to Taxonomy aligned economic activities:

In the current draft EU Ecolabel criteria for financial products, there is a requirement for a certain share of underlying activities invested in to be Taxonomy aligned. Thus, the EU Ecolabel will be awarded to financial products only if the companies they invest in carry out Taxonomy-aligned activities. It will be useful to have

an ecolabel for financial products especially for retail investors who have corresponding sustainability preferences.

The EU Climate Benchmarks Regulation lays down minimum standards for the creation of two types of climate benchmarks – EU climate transition and EU Paris-aligned benchmarks. These are to be made consistent with the EU Taxonomy by the end of 2022. The Commission will reflect on how to implement this obligation in practical terms and what obligations will be put on benchmark administrators for the selected companies or entities to form part of such benchmarks. It could be that benchmark administrators have to select companies that have a certain percentage of their activities classified as green as per the Taxonomy or that companies are excluded because they do not meet certain thresholds. The two EU climate benchmarks are largely used by market participants for the allocation of assets and should contribute to showcasing companies that have an impact on tackling climate change.

### Appendix 3 – EU Unsustainable/ Neutral Taxonomy

Below are pros and cons as identified in the EC’s consultation feedback<sup>62</sup>:

Unsustainable <sup>63</sup> taxonomy – ‘SH’ = significant harm		
	PROS	CONS
<b>SH</b>	<ul style="list-style-type: none"> <li>• An SH-extension will help identify and prioritise the economic activities for which the urgent transition towards better environmental performance has to be supported to avoid significant harm.</li> <li>• An SH-extension would increase the transparency, completeness of environmental performance levels of activities and provide an encouraging description for activities with intermediate performance levels between SC and SH.</li> <li>• An SH-extension and associated “Intermediate” area would improve framing, understanding and communication of transitions and transition plans on activity level, while improving the ability of corporates to develop strategies and investment plans to meet environmental objectives.</li> <li>• An SH extension is a prerequisite to help markets define and develop efficient instruments for financing the transition out of SH.</li> <li>• An SH extension may enhance risk management frameworks of both banks/investors and supervisory authorities as it can be assumed that SH-activities are most exposed to transition risk. Financing of associated transition plans can reduce risks.</li> <li>• An SH extension could be used by policy makers to provide subsidies to the decommissioning of harmful activities and monitor changes in capital flows.</li> <li>• An SH extension could provide clarity that other activities in an investment portfolio, even if not yet included in the Taxonomy, are not in the SH category</li> </ul>	<ul style="list-style-type: none"> <li>• An SH extension may be perceived as a departure from the positive spirit of the Green Taxonomy which aims to encourage companies to move towards sustainable activities.</li> <li>• An SH extension may risk negatively impacting the ability of high carbon intensity sectors and companies carrying out harmful activities to raise finance for transition and to innovate (blacklisting risk).</li> <li>• An SH extension could create “stranded assets by legislation”, or at least increase transparency on risks that are already there, thus increasing transition risk.</li> <li>• SH could impact the financing of companies with a high share of turnover deriving from harmful activities. Difficulties could arise linked to specific banks which frequently lend to such companies, impacting on both retail customers and on the wholesale markets.</li> <li>• An SH-extension may disadvantage EU companies vs. non-EU jurisdictions which would call for further efforts for alignment internationally.</li> <li>• An SH-extension may increase complexity, reporting burden and may affect usability and proportionality dimensions.</li> </ul>

<sup>62</sup> European Commission Platform on Sustainable Finance. (July 2021). Public Consultation Report on Taxonomy extension options linked to environmental objectives.

<sup>63</sup> As discussed earlier, sometimes referred to as ‘brown’ although the EC is seeking to retire this term.

Neutral taxonomy – ‘NSI’ = no significant impact		
	PROS	CONS
<b>NSI</b>	<ul style="list-style-type: none"> <li>• Mitigates the risk of NSI activities being compared unfavourably to green investments by markets, even when their environmental impact may be far lower than green activities in some high impact sectors.</li> <li>• Supports the greening of all parts of the economy by bringing low impact sectors clearly into the discussions on sustainable finance and supporting finance for green capex and opex in these sectors.</li> <li>• Potentially improves access to finance for low impact sectors and activities. • May be helpful for investment portfolio risk diversification.</li> <li>• May allow corporates to take a ‘whole business’ view of transition needs and support them in the greening of their supply chain.</li> <li>• Allows for emphasis on climate-resilience in small businesses which are often the most vulnerable to climate change impacts. Without NSI, these activities could be left behind in access to finance for adaptation as well as other important green actions such as energy efficiency of the buildings, electric vehicles etc.</li> </ul>	<ul style="list-style-type: none"> <li>• Potential complexity when looking to define all activities and questionable benefits compared to market-led ESG labelling.</li> <li>• Usability considerations would prioritise developing an SH taxonomy first, including DNSH criteria for otherwise low impact activities, in which case an NSI taxonomy may not be needed.</li> <li>• The logic of the taxonomy argues against the revenues of NSI activities ever being counted as green, only the green capex/opex expenditure of the entities that conduct those activities. In principle, “Green services” could be included within the existing taxonomy.</li> <li>• Scientific basis may not be well defined for all sectors.</li> <li>• Potential challenge of choosing which sectors to develop criteria for first and then how to maintain a list of NSI activities up-to-date in the dynamic services sector.</li> <li>• Some doubts as to whether NSI exists when all 6 objectives are considered, and whether any activity should be classified as NSI without having to check DNSH criteria.</li> </ul>

## Appendix 4 – Data tables

### EU-27 vs NZ household balance sheet 2020

	NZ			EU			EURbn	EU vs NZ multiple
	% of household net wealth	% of GDP	NZD bn	% of household net wealth	% of GDP	NZD bn		
Insurance, pensions and standardised guarantees	6.1	40.4	130	16.9	72.5	17,431	10,633	134
Currency and deposits	9.8	65.5	211	16.4	67.1	17,131	10,450	81
Equity in mutual funds	5.3	35.1	113	4.8	19.5	4,911	2,996	43
Listed shares	8.7	57.8	186	2.4	9.7	2,438	1,487	13
Unlisted shares / shares in unincorporated businesses	32.8	218.6	704	4.0	16.3	4,098	2,500	6
Other shares	0.0	0.0		4.0	16.5	4,141	2,526	
<b>Total equity and investment fund shares</b>	<b>46.7</b>	<b>311.5</b>	<b>1003</b>	<b>15.2</b>	<b>62</b>	<b>15,592</b>	<b>9,511</b>	<b>16</b>
Other accounts receivable/payable	0.0	0.0						
Debt securities	0.2	1.1	3.6	1.6	4.2	1,052	642	292
Housing + land	48.8	325.5	1048	63.8	260.2	65,445	39,921	62
Loans	-11.5	-77.0	-248	-13.9	-56.7	-14,258	-8,698	57
<b>Net housing wealth</b>	<b>37.3</b>	<b>248.4</b>	<b>800</b>	<b>49.9</b>	<b>203.5</b>	<b>51,186</b>	<b>31,224</b>	<b>64</b>
TOTAL	100	667.0	2,148	100.0	409.3			
Total ex net housing	62.7	418.5	1,348	50.1	205.8			
Listed shares, mutual funds, insurance & pensions	20.0			24.1				
2020 GDP			322			21,803	13,300	68
Population			5.08			448		88

Reserve Bank of New Zealand. (2020). *EU-27 vs NZ household balance sheet 2020*. [Data set].

Key observations are:

- Higher proportion of EU household's wealth (49.9%) in housing than NZ (37.3%).
- very large NZ holding in 'shares in unincorporated businesses' - being equity in sole traders, unincorporated farms, Trusts. RBNZ notes that "the most significant of these are non-corporate farms and rental properties".
- Adjusting this category to allocate an *arbitrary* \$500mn to housing + land produces the following. Of note:
  - Proportion of EU household's wealth (49.9%) in housing is still not that different to NZ (60.5%, adjusted)
  - NZ households hold proportionally more shares and mutual funds than those in Europe – an important indicator for the relevance of a green taxonomy as an enabler green for investment flows.

ADJUSTED FOR FARM/ HOUSING RECLASSIFICATION	NZ			EU			2020	
	% of household net wealth	% of GDP	NZD bn	% of household net wealth	% of GDP	NZD bn	EURbn	EU vs NZ multiple
Insurance, pensions and standardised guarantees	6.1	40.4	130	16.9	72.5	17,431	10,633	134
Currency and deposits	9.8	65.5	211	16.4	67.1	17,131	10,450	81
Equity in mutual funds	5.3	35.1	113	4.8	19.5	4,911	2,996	43
Listed shares	8.7	57.8	186	2.4	9.7	2,438	1,487	13
Unlisted shares / shares in unincorporated businesses	9.5	63.4	204	4.0	16.3	4,098	2,500	20
Other shares	0.0	0.0		4.0	16.5	4,141	2,526	
<b>Total equity and investment fund shares</b>	<b>23.4</b>	<b>156.2</b>	<b>503</b>	<b>15.2</b>	<b>62</b>	<b>15,592</b>	<b>9,511</b>	<b>31</b>
Other accounts receivable/payable	0.0	0.0						
Debt securities	0.2	1.1	3.6	1.6	4.2	1,052	642	292
Housing + land	72.1	480.7	1548	63.8	260.2	65,445	39,921	42
Loans	-11.5	-77.0	-248	-13.9	-56.7	-14,258	-8,698	57
<b>Net housing / land wealth</b>	<b>60.5</b>	<b>403.7</b>	<b>1300</b>	<b>49.9</b>	<b>203.5</b>	<b>51,186</b>	<b>31,224</b>	<b>39</b>
TOTAL	100	667.0	2,148	100.0	409.3			
Total ex net housing	39.5	263.2	848	50.1	205.8			
Listed shares, mutual funds, insurance & pensions	20.0			24.1				
2020 GDP			322			21,803	13,300	68
Population			5.08			448		88
Farm/ rental adjustment			500					

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