

# Paint it brown

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After devising a taxonomy of green activities, the EU has been called on to create a 'brown' taxonomy. Would it be a help, or an unnecessary complication, asks **Christopher Marchant**



The proposed taxonomy of green activities that will underpin the EU's Sustainable Finance Action Plan was finalised and submitted to the European Commission in March.

The taxonomy – essentially a list of activities that are approved as being beneficial in terms of climate mitigation or adaptation – was the culmination of almost two years of work for the EU Commission appointed technical expert group on sustainable finance (TEG).

It was a painstaking endeavour that involved two consultation periods and input from the 35 members of the TEG, and hundreds of other experts and market participants.

But the final report, to the surprise of some, contained a call for the creation of a 'brown taxonomy' in addition to the green taxonomy, to identify the areas of industry doing significant harm to the environment.

*So, what benefits might a brown taxonomy bring, what might it look like, and how would it be used?*

Work to define a green taxonomy was started by the Commission, with the aim of helping finance flow towards a list of activities that are officially classified as making a substantial contribution to environmental goals. It was hoped that the creation of such a list would help eliminate claims of 'greenwashing' that undermine confidence in sustainable financial products.

But while work to create the green taxonomy was ongoing, calls were growing for a brown taxonomy to help actively steer finance away from harmful activities.

The European Central Bank earlier this month threw its weight behind these calls.

"Developing criteria for significantly harmful emission levels will help investors, companies, issuers and project promoters understand the necessary speed and depth of the transition task ahead" – TEG final report on the EU taxonomy

Nathan Fabian, chief responsible investment officer at Principles for Responsible Investment (PRI) and rapporteur for the taxonomy working group of the TEG, outlines the rationale for a brown taxonomy: "Not every activity in the economy can align with [the] environmental objectives. There are a lot of assets and economic activities that have very high emissions levels, and the market needs some guidance about what to do with those assets, how to improve their performance and then transition them out of the economy."

A brown taxonomy may have an important role to play in helping to realise the objectives of the EU's Sustainable Finance Action Plan. This includes provisions such as the requirement for investors to be asked for their sustainability preferences. Here, the brown taxonomy may be critical, as investors may want to express what they specifically do not want to finance, explains Nancy Saich, chief climate change expert at the European Investment Bank (EIB).

She thinks this approach will become de rigueur: "My daughter is nearly 17 – in a few years she may be making an investment decision on her phone, simply ticking 'yes' to climate action, 'yes' to favourable ESG-linked investments, and 'no' to brown.

"When that starts to happen, if only 5% or 10% of investors start to express that kind of preference, that's hugely powerful. For the industry to be able to handle that, it's going to need a clear language for the brown end of the scale."

The green taxonomy system devised by the TEG has six environmental objectives: climate change mitigation, climate change adaptation, biodiversity, water, waste and pollution, and the circular economy.

In order to qualify for the taxonomy, an activity has to show that it substantially contributes to one of the six objectives, and does no significant harm (DNSH) to any of the other five objectives. (See box.)

The TEG has drawn up thresholds that an activity must meet to be considered green, and separate DNSH criteria.

Creating a brown taxonomy to complement the green taxonomy would effectively create three layers of classification. Between brown and green would be a 'grey area' in the middle, for activities that are considered to make 'neither substantial contribution nor do significant harm', according to the TEG.

Breaching a DNSH threshold could be enough to put an activity into the brown category, even if it also meets the thresholds for significant contribution to another of the five objectives, according to Fabian.

By establishing the brown criteria, the taxonomy could support a much clearer conversation about transition pathways for reducing pollution to help meet the Paris Agreement targets, he argues.

"Then, if you believe markets will exercise preferences around the criteria and policy signals start to align with the criteria, you influence levers that impact demand for the products that perform at that level, and then that starts to impact pricing and the prognosis for high emissions activities," says Fabian.

The brown taxonomy criteria can then potentially help drive an overall reduction in carbon emissions across the EU, as companies attempt to transition from brown to a middle or grey category and, if regulations tighten further, from the middle category to green.

## What is brown?

The most critical, and potentially controversial, consideration for the brown taxonomy is what is going to be included, and what is going to escape the label.

The shape of such a brown taxonomy is unknown. However, it could follow a model similar to the climate mitigation taxonomy proposed by the TEG. This has adopted a science-driven, technology-neutral approach that set thresholds for different types of technology to be eligible with a transition pathway to being aligned with the Paris Agreement.

For example, power plants would be required, under the TEG's green taxonomy proposal, to emit no more than 100 grams of carbon dioxide (CO<sub>2</sub>) per kilowatt hour including lifecycle emissions, in order to qualify.

While the criteria are not sector-specific, Fabian believes that no unabated fossil fuel source could ever meet this limit.

The EIB's Saich argues that if a natural gas plant were to be extremely efficient and use carbon capture and storage, it could possibly have emissions that are lower than the climate mitigation DNSH criteria for the power generation sector of 262 grams of CO<sub>2</sub> per kilowatt hour. This number acts as a threshold as to what may be in the words of Saich "unsustainable finance", as opposed to the 100grammes/kWh criteria which is for making a 'substantial contribution' to the climate mitigation objective. To emit between these two numbers is to fall into the grey DNSH category.

If that DNSH criteria is used for the brown taxonomy – then such power plants would avoid inclusion in "brown", even if they never reach the "green" criteria for climate change mitigation.

Because the TEG broadened its approach during 2019 to include sectors that need to transition, as well as those that are clearly green, it devised thresholds even for high-emitting industries, such as cement and steel. The TEG's suggested threshold for cement clinker manufacturing is: 0.8 tonnes of CO<sub>2</sub> emissions for every tonne of clinker, and for steel in the 'hot metal' stage of production, it is 1.3 tonnes of CO<sub>2</sub> emissions for every tonne.

Of the six environmental considerations to be tackled by the TEG, only climate change mitigation and climate change adaptation are currently included in the green taxonomy. The remaining four criteria have yet to be written, and are set to be followed by social considerations.

In some cases, such as in the energy, manufacturing and transport sectors, quantitative performance-based DNSH criteria have already been written. For example, the main DNSH issues deriving from the operation of rail transport activities arise from air pollution, noise and vibration.

For biomass plants, the technical annex to the taxonomy notes that key environmental aspects to be taken into account when investing are the impact on local water supplies and the avoidance of direct impacts on sensitive ecosystems, species or habitats.

The TEG report says it may be possible to use these as the thresholds for future 'brown' technical screening criteria, but it "recommends that further work is conducted to validate the approach before the DNSH criteria are used as de facto brown thresholds".

However, in many cases, DNSH criteria have not yet been written, such as for the nuclear power sector. This sector failed to be included in the green taxonomy despite its low-carbon credentials due to concerns that it could do significant harm from the waste it creates and a lack of the technical expertise necessary to reach a firm decision on this.

"Any problem with the brown taxonomy depends on how you define it," argues the EIB's Saich. "It's important to encourage the low-carbon transition – and that has to be fast and it has to be ambitious.

"It's important that, however it's pitched, however they define it, it does support that transition and does not exclude certain sectors from financing. If they are excluded from any financing, they won't be able to transition."

Sandrine Dixson-Decleve, co-president of the Club of Rome and a member of the TEG, adds: "This is not about us making random decisions to decide which economic activities are bad or good. The conversation is [about how] we are supposed to meet our objectives for decarbonisation."



Sandrine Dixson-Decleve

## Three-tier system

Last September, then-governor of the Bank of England, Mark Carney claimed that the EU's taxonomy on sustainable activities was "a good start", but a "richer" taxonomy that does not take a binary approach is needed, calling for a '50 shades of green' approach.

Fabian believes the TEG's support for a brown taxonomy may combat these claims: "Generally, people in the market underestimate how much of a change is needed in environmental performance in order to be consistent with environmental goals.

"The purpose of having explicit green performance or sustainability performance criteria was to demonstrate exactly how far those performance levels are away from where we are today, and to get away from the argument that any shade of green is good enough. So we had to go for something explicit and binary on that side of the equation."

On Carney's '50 shades of green' approach, Fabian says: "I would say transition questions are really fundamental in



Kristina Rüter

terms of countries meeting climate goals, and the globe meeting international agreements.

"Whether or not the market would be benefitted by, or be better off with, 50 different shades of green – well, that is exactly what we're trying to avoid, because then who knows what's good enough? That is exactly why some clear criteria are needed."

Fabian added: "The benefit of 'brown' taxonomy thresholds is that they can be used to clearly signal when improvements to existing assets make a substantial difference to the environmental performance of an activity or asset, even if that performance still does not align with environmental objectives."

"The benefit of 'brown' taxonomy thresholds is that they can be used to clearly signal when improvements to existing assets make a substantial difference to the environmental performance of an activity or asset, even if that performance still does not align with environmental objectives" – Nathan Fabian

However, some market participants still feel that a more nuanced methodology than the three-tier system proposed by the TEG is needed.

Kristina Rüter, head of methodology at data provider ISS ESG, has "concerns" that the three-tier approach suggested by the TEG "might not [provide] the distinction and guidance investors need in order to comply with their own or their clients' investment strategies".

"We support a taxonomy methodology that does not only clarify the 'greenness' of business activities, but that also creates transparency about which business activities are not sustainable or environmentally friendly," she says. But she adds: "ISS ESG advocates and practises not a binary approach but a scale, from dark green over light green to grey, and further to light red (negative) and dark red."

"It must not be forgotten that this means that large parts of the economy's business activities will be classified as 'grey' – that is to say neither green nor negative. Thus, from our perspective, the risk of sudden capital shifts due to investors rapidly withdrawing capital from negative business activities, resulting in instability and bubbles, is not as high as some stakeholders see it – but investors would profit from [enhanced] transparency."

She envisages "a sustainability barometer using a scale of colour schemes", which could be applied at the issuer level (e.g. for bonds) as well as being aggregated on the financial product level (e.g. investment funds).



Nathan Fabian

Jacob Michaelsen, head of sustainable finance advisory at Nordea Markets, says there are many complications that may potentially arise from discussions outside of strictly

This could resemble the EU energy efficiency label for appliances and buildings, she suggests, or the nutritional value and ingredients tables on food products.

"For the latter, producers have to disclose not only positive nutritional value, but also fat and sugar content. If we can identify and classify ingredients with a negative impact, why can we not do the same for economic activities with a negative impact?"

Jacob Michaelsen

'green' considerations, such as the social ones: "If one were to apply a DNSH consideration, you might need to go a bit further out in the chain of consequences, from which you can certainly see what happens when you turn off the gas valve, for example."

"Turning off natural gas without having an energy alternative for a community could be surmised as a significant harm on a social parameter. That's why I think it may be relevant to look at the taxonomy not as green and brown, or good versus bad, but rather in its totality. The fact that the final TEG report highlights both 'brown' and 'social' criteria I think is a good reflection of such a holistic perspective."



## Capital requirements

In 2018, a report from think tank the 2 Degrees Investing Initiative (2DII) assessed the potential impact of the EU introducing a 'green supporting factor' or 'brown penalising factor for banks' capital reserve requirements.

The current small to medium-sized enterprise (SME) supporting factor, implemented under the EU's Capital Requirements Directive, allows banks to reduce capital requirements for credit risk on exposures to firms with a turnover of below €50 million. This means that banks can free up capital resources that can be redeployed in the form of new loans.

The conclusion from the 2DII was that an equivalent green supporting factor for environmentally-friendly investments would have a limited effect compared with the current SME supporting factor. But a brown penalty - in the form of higher capital reserve requirements on carbon-intensive investments - may have a more noticeable impact on investments in high-carbon assets. It cited research that shows a brown penalising factor could impact lending volumes by up to 8%.

This is partly because the universe of brown assets is bigger than that of green assets.

The results suggest that brown penalties could create total additional capital charges for the EU banking sector of up to €25 billion for capital charges of 15% to 25%, and up to almost €40 billion if the penalty goes as high as 50%.

"A brown penalty through strengthening capital reserves would ... not be expected to have a negative impact on financial stability but would be expected to generate noticeable capital effects," said the report. "While this policy instrument enjoys higher support from the NGO community, it is also likely to see stronger resistance from the private sector."

Regulators at the UK's Prudential Regulation Authority told an *Environmental Finance* conference on Insurance and Climate Risk that there is a lack of evidence that green investments are lower risk. They preferred the concept of a brown penalising factor to a green supporting factor, because there was more evidence that high-carbon assets were at risk of being devalued amid the transition to a lower-carbon economy.

However, the concept remains controversial – many warn about the dangers of using capital requirements for purposes other than safeguarding solvency.

Michele Lacroix, head of the group investment office at French reinsurer SCOR, opposes the idea: "You can be more emitting but less risky than another company that can be a little less brown, for whatever reason.

Activity should not be the driver for a capital charge.

"If you want to focus investment in one sector and to reduce investment in another, you should never use a capital charge or equivalent. If you disconnect capital charges from risk management, from risks borne by your investment, you open the door to something which is not acceptable."

## A tool for policymakers

One of the most important applications of the EU's taxonomy may be as a tool for policymakers and regulators. Just as a green taxonomy could help policymakers know which industries to incentivise, a brown taxonomy could help guide disincentives or penalties.

It could, for instance, help to guide countries away from subsidising fossil fuels, says Fabian. A 2019 analysis by the UK's Overseas Development Institute showed that only nine EU countries had outlined their commitment to end fossil fuel subsidies as part of their national climate plans, since the EU pledge to do so at the G20 meeting in 2009. Germany, Greece, Poland, and Slovenia are even looking to introduce new subsidies by 2030. According to Fabian, the removal of these incentives may offer a starting point without undue disruption to the marketplace.

There are signs of this beginning to happen. The European Commission's €750 billion (\$825 billion) Covid-19 recovery fund will be geared around climate action, and will use the EU's taxonomy as a guide. A brown taxonomy could therefore similarly be used to steer investment.

## Reporting

Arguably, the need for a brown taxonomy was demonstrated by recent controversy over a draft document from the European Securities and Markets Authority which omitted oil and gas from its definition of fossil fuel sectors in draft ESG disclosure requirements. A brown taxonomy could have given it an official reference point to adopt in disclosure requirements.

Reporting of harmful activities is an important consideration if a brown taxonomy is to be effective. Under the current proposal for the green taxonomy, financial products without sustainability objectives can opt out of reporting on their alignment with the taxonomy, instead opting for a standard disclaimer, warns Rüter at ISS ESG.

"If transparency about the 'greenness' of business activities is only demanded for the sustainable investment niche, the taxonomy will not be a successful measure to shift capital flows in a dimension that is necessary to reach the EU's environmental targets," says Rüter.

"Expanding the taxonomy to cover negative activities as well as requiring disclosure on taxonomy alignment for all financial products, without a non-reporting option, would ensure comparability, promote investing in green business activities and share the reporting burden. It would be an important signal for investors and issuers."

France's Article 173 obliges institutional investors to publicly report ESG criteria, specifically those related to climate change, within their policies. An EU-wide adoption of such a measure may be essential for the brown taxonomy to have any teeth, says SCOR's Lacroix.

"There may be a risk because it may look like a name and shame [approach], but if we want companies to move forward, we need to increase transparency. Let's be clear, this is how green finance has evolved," she says.

## Next steps

The Commission, under the political agreement establishing the TEG, must conduct a brown taxonomy study to be delivered by the end of 2022.

The TEG's current mandate is due to end in September, so should the Commission heed the call of the TEG and develop a brown taxonomy, the job of defining it will fall on a 'Platform on Sustainable Finance'. The Platform is expected to be appointed by the Commission later this year to advise it on developing eligibility criteria for the four remaining environmental objectives, and to consider whether the taxonomy should be extended to cover social objectives and 'brown' activities.

There is, however, discussion as to whether it will even be called a 'brown' taxonomy, with resistance from American and other investors to labelling investments in such a manner, says the EIB's Saich. There is the possibility of it being called a 'red' taxonomy, though there is likewise cultural concern that this colour is celebrated across East Asian markets and may lead to similar confusion.

Saich offers the alternative of a Doing Significant Harm category, bypassing colours completely, and fully acknowledging that such a designation signals a breach of DNSH principles.

There is therefore a long list of difficult decisions to be made. But first, the EU needs to appoint the Platform.

Who should be on the Platform, how many members should it have, and what should be its mandate? That's another grey area.

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## Making it into the green taxonomy

In order to be eligible for the green taxonomy, an activity has to meet the 'significant contribution' thresholds for one of the six environmental objectives.

These are: climate change mitigation, climate change adaptation, biodiversity, water, waste and pollution, and the circular economy.

Next, it must be classified as 'doing no significant harm' to any of the other environmental considerations.

Finally, it must meet minimum social safeguards, represented by the International Labour Organization's declaration on Fundamental Rights and Principles at Work. Adopted in 1998, its categories include freedom of association and the effective recognition of the right to collective bargaining, the elimination of forced or compulsory labour, the abolition of child labour and the elimination of discrimination in respect of employment and occupation.

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