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WILL EUROPE GIVE AWAY ITS CLIMATE LEADERSHIP?

WHY A STRONG SUSTAINABLE FINANCE TAXONOMY IS CRUCIAL FOR EU INTERNATIONAL LEADERSHIP

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Lowering the ambition of the EU's green taxonomy creates a cascading geopolitical risk. Weak European sustainable finance standards would lead to other major economies taking steps that would conflict with EU climate policy objectives and weaken Europe's role as a leading regulator.

This briefing makes the case for ensuring that the economic activities included in the EU green taxonomy continue to be categorised in line with the principles set out in the Taxonomy Regulation, to avoid reputational damage for Europe, and the weakening of climate ambition internationally.

The EU taxonomy is a tool for defining which economic activities are classed as 'sustainable'. The taxonomy now also has the visibility and symbolic power to define the 'green' in European Green Deal. Although not preventing investments in harmful and polluting activities, it is a transparency tool preventing them from being marketed to investors as 'green'. Whether investors rely on the taxonomy and actually use it, however, is highly contingent on their trust in its objective and scientific grounding. Asset Owners are already expressing concerns that taxonomy criteria deviating from science could cause serious reputational damage and would not be a useful financial tool for market participant.

By creating the green taxonomy the EU has set a bold new international finance norm, expanding its role as the premier global regulator. Around 20 other jurisdictions have now followed the EU's example by creating their own taxonomies, including India, Russia, Indonesia and the United Arab Emirates. At

COP26 the EU-led International Platform on Sustainable Finance (IPSF) released a **Common Ground Taxonomy** bridging the EU and Chinese taxonomies.

The EU may now undermine its own regulatory process and principles. This would result in a loss of trust and reputation among market actors. Progressive elements of the financial sector are already pushing back and **asking that the taxonomy remains a "green" list** in order to be useful, and there is discussion of whether the EU is ceding its regulatory leadership role to China.

This change would be entirely unnecessary, because the existence of the green taxonomy does not prevent any kind of investment. There will always be some projects and activities that are worth investing in over the short term even if they may not be compatible with climate neutrality in 2050. This is not a reason to add these activities to a "green" list. However, absence of a credible green list would make it difficult for Europe to build green markets at home and abroad.

A decision by the EU to weaken its "green" list is likely to be replicated by other major economies including South Korea and Indonesia. This would be damaging to climate action overall, weakening global momentum towards achieving the goals of the Paris Agreement.

Background: Europe's green taxonomy

The EU's green taxonomy sets out a list of economic activities that make a 'significant contribution' to European environmental policy goals, in order to inform investors and avoid greenwashing. The Taxonomy Regulation was passed into EU legislation in 2020, but the technical details have proven difficult to finalise. The climate change criteria proposed by the European Commission in April this year in a Delegated Act are awaiting approval by Member States.

Some of the most politically contested issues relate to the energy sector, where the current proposal does not include thresholds for nuclear energy and natural gas. These activities will both be covered in a new Delegated Act to be published very soon, and several proposals have been made as to how the two energy sources could in some way be included on the "green" list.

It would be extremely difficult to reconcile the inclusion of gas-fired and nuclear power on the "green" list with the science-based principles set out in the Taxonomy Regulation. Key issues include:

- Investment in gas-fired power generation is not compatible with the EU's 2050 climate neutrality goal. The IPCC's report on 1.5 degrees makes it clear that no new fossil fuel infrastructure can be built if this temperature goal is to be achieved.

- Investment in nuclear power generation was not included in the taxonomy drawn up by the EU's Technical Expert Group on the basis that it does not meet the taxonomy's "Do No Significant Harm" requirements which are set out in the Taxonomy Regulation.

The taxonomy refers to scientific thresholds, but how it is used is a political decision. In the case of climate change, the taxonomy's approach to 'what is green' has so far been based on the best current understanding of climate science and what is required to reach the EU's goal of climate neutrality by 2050.

If certain economic activities are not included on the "green list" there will be no accompanying restriction on the ability of the private sector or Member States to finance these activities. Some of the actors in current debates appear to have misunderstood this point, which has led to politicisation of what should be a technical and science-based process.

A departure from the use of science-based evidence in the Delegated Act is likely to cause environmental groups to disengage from further participation in the taxonomy process. The multi-stakeholder Platform on Sustainable Finance set up to govern the taxonomy has a substantial forward work program around non-climate and social objectives. Undermining the Platform would further erode the taxonomy's legitimacy, calling into question the integrity of Europe's overall leadership on climate change.

Implications for Europe's international climate leadership role

If Member States agree a "green" classification process for economic activities that is not aligned with climate neutrality by 2050, the credibility of the Green Deal among European citizens and market actors will be cast into doubt. The European Green Deal has become Europe's calling card internationally to signal its identity and values. Climate action is at its heart, as symbolised by Europe's new Climate Law.

Reputational damage has already been done abroad by Europe's decision not to use the Paris-aligned taxonomy to guide its green recovery spending. Europe's role as a green finance standard-setter is now also in doubt. The EU is currently issuing unprecedented quantities of green recovery bonds, but these do not comply with its own taxonomy-aligned EU Green Bonds Standard. If the EU taxonomy is weakened further, the EU Green Bonds Standard will become weaker than existing market standards such as the Green Bonds Principles. This will put at risk the whole European green bond market, rendering the EU standard useless to market participants and a lasting embarrassment to Europe.

Allowing for greenwashing criteria in the taxonomy would also affect negatively the overall EU sustainable finance regulatory framework. Disclosure requirements for financial market players for instance, include taxonomy-aligned disclosures under the SFDR – Sustainable Financial Disclosure Regulation. The taxonomy is also vital for assessing investors' sustainability preferences under MIFID 2 – Markets in Financial Instruments Directive. Weak taxonomy criteria would thus undermine the investors' confidence and trust in all sustainable finance products and services, in direct opposition to the goals of the new Sustainable Finance Strategy.

Market participants are already signalling concerns about the usefulness of the taxonomy if it deviates from science, which will introduce them to significant reputational risks. The UN-convened Net-Zero Asset Owner Alliance, representing $10 trillion in assets, **has already criticised the inclusion of gas and nuclear in the taxonomy.** Similar finance industry led calls have been initiated in other problematic sectors, where taxonomy criteria are at risk of greenwashing. Another group of global investors have communicated to the Commission their concerns about greenwashing in the expected agriculture criteria.

If Europe reduces its ambition level, other major economies will have an excuse to follow suit. The UK Government is already working on its own sustainable finance taxonomy based on the EU's version. To maintain market access the UK wishes to diverge from EU standards as little as possible, but the government is subject to substantial lobbying pressure from the gas and nuclear industries. If Europe departs from a science-based approach it will be much harder for the UK to maintain alignment with the Paris Agreement.

The risk of a race to the bottom is particularly acute for major economies in Asia. South Korea will finalise its own green taxonomy by the end of 2021 and recent leaks suggest that the country is now **seriously considering** including gas-fired power generation. The Korean Environment Ministry **has explained** that the continued debate over this issue in Europe has influenced their decision not to exclude unabated gas power from its "green" list, although nuclear power is still excluded.

The EU-influenced Korean decision is likely to cascade through to influence other major economies in the region, including Indonesia which will hold the G20 Presidency in 2022 and is also expected to publish a green taxonomy in that year. A weak Indonesian taxonomy would set a global precedent that could destroy the impact of Europe's work to mobilise green financial flows for global climate transition. The door would be opened for jurisdictions which have already published taxonomies that are not Paris-aligned, including Japan and Canada, to facilitate a fragmented and meaningless regulatory landscape. As a result, it will become much harder to mobilise financial flows for low-carbon development in line with the Paris Agreement's finance goal, and extremely difficult for the EU to shape green finance standards in the future.

If Europe put its leadership on defining market standards for climate neutrality at risk, other countries including China will quickly step in to fill the gap. By including gas and nuclear energy in the green taxonomy, Europe may be opening the door to letting China take the lead on green financial standards internationally. At COP26, Europe and China jointly presented a **Common Ground Taxonomy** which does not include power generation from nuclear energy or fossil gas. For Europe to depart from the level of ambition shown at COP26 would be taken as a clear statement of abdication of climate leadership, especially as China is already more ambitious than Europe in some areas including electricity generation using solar photovoltaic technology and production of some renewable energy equipment. Remarks made by Timmermans during the climate talks **have already been received in this way**.

China has been active through 2021 in setting green financial standards and is well placed to pick up the EU's leadership role in 2022. China has worked with the EU to co-chair the Taxonomy Working Group of the International Platform on Sustainable Finance and is working with the United States to co-chair the G20 Working Group on Sustainable Finance. The US-China climate change partnership announced at COP26 demonstrates China's determination to be one of the top two global climate leaders.

Europe's visible internal split around defining "green" has eroded its climate leadership on the international stage. In the past year Europe has been divided over the classification of gas-fired and nuclear power generation, creating two opposing fronts of Member States. At COP26 in Glasgow this weakened the EU's voice and leadership on climate action. For example, Germany, Austria, Luxembourg, Denmark and Portugal isusued a **joint declaration** during the conference arguing against the positions of fellow Member States. Meanwhile, Russia was happy to recently finalise its own **green taxonomy** which excludes gas-fired power generation.

Key lines to take:

> **The EU's role as a global regulator, and the credibility of its 2050 climate neutrality goal are both at risk**: It may not have been the Commission's original intention, but the taxonomy now has the power to define the 'green' in Green Deal. Delivering an evidence-based tool through a robust regulatory process will be essential for the credibility of the EU's leadership both domestically and internationally.

> **An unwise decision now by the EU will create an international 'race to the bottom' dynamic**. Korea is already using the EU debate as an excuse to weaken its green taxonomy, and there is a plausible risk of further contagion to Indonesia and other jurisdictions.

> **We don't have time to get this wrong:** Climate goals such as the EU 2050 climate neutrality target, and the Paris Agreement temperature goal to limit climate change to 1.5 degrees of warming, require the energy sector to be decarbonised by mid-century, and also require a massive scaling up in green investment. Classifying investments that have no long-term future under the Green Deal as "green" would make it difficult either to end financing of future stranded assets or to build the new markets that are needed for the climate transition.

> **There is still time for Europe to change its mind and retain a science-based approach.** The EU will appear stronger overall if it holds the line on Paris and 2050 climate neutrality, despite recent public statements.

About E3G

E3G is an independent climate change think tank accelerating the transition to a climate-safe world. E3G builds cross-sectoral coalitions to achieve carefully defined outcomes, chosen for their capacity to leverage change. E3G works closely with like-minded partners in government, politics, business, civil society, science, the media, public interest foundations and elsewhere.