An expert view on sustainable finance

What to aim for with the sustainable finance taxonomy?

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Karsten Neuhoff, DIW Berlin, Alexander Bassen, Hamburg University, Timo Busch, Hamburg University, Ingmar Juergens, DIW Berlin, Christian Klein, Kassel University, Ulf Moslener, Frankfurt School of Finance; Franziska Schuetze, Global Climate Forum

We discuss the sustainable finance taxonomy initially with a focus on the climate dimension of sustainability[1], while the concept of sustainable finance is significantly wider, comprising besides environmental also the social and governance dimensions of finance[2].

The sustainable finance taxonomy is supposed to form the reference base for the EU action plan's other objectives of (i) influencing financing decision and managing financial risks; and (ii) reorienting financial flows.

One risk of the EU taxonomy, considering its tight time line, is that it will be limited to existing data and approaches to measuring ESG or GHG emissions and take an overly static view of sustainability, defining green sectors rather than green strategies across the economy and ex-post assessments of climate/ESG impacts rather than climate/ESG dynamics (including future dynamics). While even a static approach may improve access to finance for firms that are categorized as particularly sustainable and encourage companies to "get rid of" (sell or outsource) carbon intensive activities, it also raises three principle questions:

1) Will this help reaching climate targets? A "simple" change of ownership does not change emissions, and even closure of "dirty" plants (e.g. in Germany or the EU) will not impact emissions as long as the demand for emission intensive products is not reduced but rather met by other production sites (e.g. outside the EU).

2) Will it advance innovation and investment in Germany/the EU? If progressive, technology oriented firms divest from carbon intensive manufacturing activities (like primary material production) in DE/EU to improve their carbon intensity, they are less likely to engage in innovation and investment in low-carbon materials and production technologies in DE/EU.

3) Will it capture risks of business models not aligned with climate policy targets?

While the high-emitting sectors that require major innovations, like conventional steel making, can be identified with a static taxonomy (focusing on current emissions), a dynamic approach will be able to look beyond past performance and also capture whether a steel firm (by static definition not in a green sector) is already mitigating their carbon risks with a well-executed transition strategy toward a low-carbon production process.

These examples illustrate, that a static appraisal of carbon intensity, absolute emissions or a mere classification based on sectors or product types will ultimately not suffice (i) to identify risks of carbon

[1] In the entire document, we use carbon and climate change as exemplary for the broader sustainable development challenge that a sustainable finance agenda will ultimately need to embrace.

[2] For more information about sustainable finance and how it can be defined see for example: European Commission https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_en ; IFC: https://www.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/Sustainability-At-IFC/Company-Resources/Sustainable-Finance/ or UNEP inquiry: http://unepinquiry.org/

intensive business models and strategies; (ii) to support firms in the implementation of innovation and investment strategies compatible with climate objectives and (iii) to inform financing and investment decisions compatible with the climate objective. Financial institutions, financial regulators and supervisors, rating agencies, analysts, advisors, investors and savers need information on whether a firm's business model and strategy is compatible with future requirements and developments (in terms of innovation, technology, regulation and market structure) or not.

The further development of the taxonomy requires a clear definition of the taxonomy's goals, a dynamic approach to risk, and an extended scope.

Define the goal of the taxonomy

A number of functions the taxonomy should fulfil, have been identified by experts and stakeholders

To ensure a contribution of sustainable finance to the science-based climate policy target signed up to in the Paris agreement, the taxonomy will need to capture long-term and strategic risks and opportunities. To effectively integrate long-term targets and thinking into actual decision making in the financial system, climate scenarios defining the science-based space of action, need to be made usable in the context of banking, investment and capital market transactions.

Build the taxonomy on a dynamic, forward-looking view of risk and sustainability

The current/emerging discourse is a first step but needs to be open for further development with a more dynamic scope in mind

In line with its key objectives of (i) influencing financing decision and managing financial risks; and (ii) reorienting financial flows, the taxonomy will need to go well beyond a static view of risk and sustainability (which prevails in existing indicators and evaluation frameworks provided by CDP and used by firm data providers like Bloomberg, Reuters et al.) and be developed with a dynamic and forward looking view in mind. It will have to reflect sustainable (and low-carbon) trends, changes and strategies across the economy (rather than for example merely defining green sectors) and consider future rather than stopping at an assessments of the status quo.

What initial learnings can we built upon?

- Scenarios exist, but differ in the specific policy and technology pathways they envisage, their degree of detail and applicability in the concrete "use case".
- Transparency of assumptions in underlying scenarios is essential to allow for appraisal and comparison between scenarios, while iterative processes of scenario generation and cross sectoral alignment (and hence coherence) have proven essential.
- Compared to well-established quantitative indicators used for carbon emission accounting and reporting, the evaluation of strategic orientation and climate objective compatibility will need to be open to a mix of qualitative and quantitative metrics or sector specific metrics.

Develop the scope and structure of the taxonomy

Ideas for the further development of the taxonomy's scope

Ultimately it will be necessary to appraise whether the positioning and strategy of a firm or public entity are in line with climate policy objectives and how the required transition could be adopted by a given company. This includes for example the question whether the scale of the markets a firm envisages for its products is compatible with the overall low-carbon transformation of the economy (e.g. the gasoline demand a refinery expects), or whether the technologies it uses to serve these markets will remain competitive if embodied carbon emissions are fully priced or otherwise regulated.

Such appraisals are increasingly emerging, triggered by various initiatives:, including the Transition Pathways Initiative (of LSE's Grantham Institute, FTSE Russell and PRI, http://www.lse.ac.uk/GranthamInstitute/tpi/about/partners/) the Science based targets initiative (in partnership with CDP, UN Global compact, WRI and WWF, https://sciencebasedtargets.org/) or Decarbonisation roadmaps being developed at economy, industry, and sector level (BDI, DENA; EU sector road maps by industry associations).

What are implications for the structure of a sustainable finance taxonomy?

- A gradual implementation/development of the taxonomy could include trigger levels or proportionality measures to initially focus on the most relevant sectors and limit complexity.
- How / why are scenarios relevant to benchmarking, asset valuation and investment decisions? And what could converging scenarios look like for different actors?
- What opening/development options are required to ensure flexibility and revisions for the further development and expansion of the taxonomy and its scope?
- Enabling users to apply the sustainability taxonomy requires capacity building/training/learning.

Consider implications of taxonomy's scope for disclosure and reporting

As regards the alignment of the taxonomy's scope with disclosure and reporting, a set of important questions will need to be addressed:

- What reporting is for internal audits and what for public reporting? How to best align different reporting formats and how to set the right levels of reporting (in terms of quality, detail, etc.) for different purposes; which metrics work for whom and capture static and dynamic risks?
- Regulation of reporting: Which existing legislation "works" (has which effects) and could be adopted at EU level? How can the initial experience with science-based targets and forward-looking reporting be integrated in corresponding disclosure "rules" (voluntary or mandatory)?
- Quality (control) of reporting: How to move disclosure from primarily ex-post/static assessments towards a forward-looking perspective, while ensuring comparability (e.g. standardized scenarios?) and allowing for third party verification?

Summary

These observations and ideas from our discussions so far can be summarized as follows:

A taxonomy building on existing static indicators and definitions is only a first step. It is crucial to differentiate what can already be reflected in current taxonomies and what needs to be added later, in terms of the dynamic view. In this sense, it is important to avoid the risk of a lock-in that may hamper innovation and investment in sectors that have large potentials to decarbonize, but would currently not be classified as green. The design of the taxonomy needs to keep the idea of facilitating further developments and adjustments in mind.

The structure of the taxonomy should cover all asset classes and extend beyond investment to also cover the lending and banking side.

Procedural and governance perspectives of the discussion need to result in a structure that allows for regular reviews and consider how the short-term activities (already foreseen in the EU Action Plan) affect long-term visions of the necessary framework. It needs to be flexible enough to deal with conflicting goals, build on and improve existing definitions of sustainable investments (see e.g. Hoffmann, Scherhorn and Busch, 2003; FNG label, etc.) and link to activities outside the EU action plan, in the context of the TCFD, ISO, etc..

After a big international conference[3] in Berlin in February 2018 served as first major public exchange of views and get together of experts to discuss the recommendations of the EU's expert group and the EU action plan, we sat down with a couple of interested colleagues from various institutions active in the field of "sustainable finance" (mostly researchers, but also CSR-practitioners, think-tanks, NGOs and ministry colleagues) and decided that it would be good to have a "place" to continue these discussions; with a focus on our comparative advantage, namely the contribution of (applied) research and analysis to a successful implementation of a framework for sustainable finance (including the EU action plan).

The aim of this informal group is an open, informal exchange to promote the discourse on "sustainable finance" from a research point of view and to constructively work together from our different research areas and experiences. In a set of two initial workshops/roundtables, on 4 May 2018 and 27.8.2018 in Berlin, we have explored what are the most urgent sustainable finance questions. The initial focus has been on the sustainable finance taxonomy and the following shared perspective among the participating researchers emerged from our discussion so far.

[3] https://www.diw.de/en/diw_01.c.579716.en/research_advice/sustainability/climate_policy/events/high_level_conference_on_sustainable_finance.html