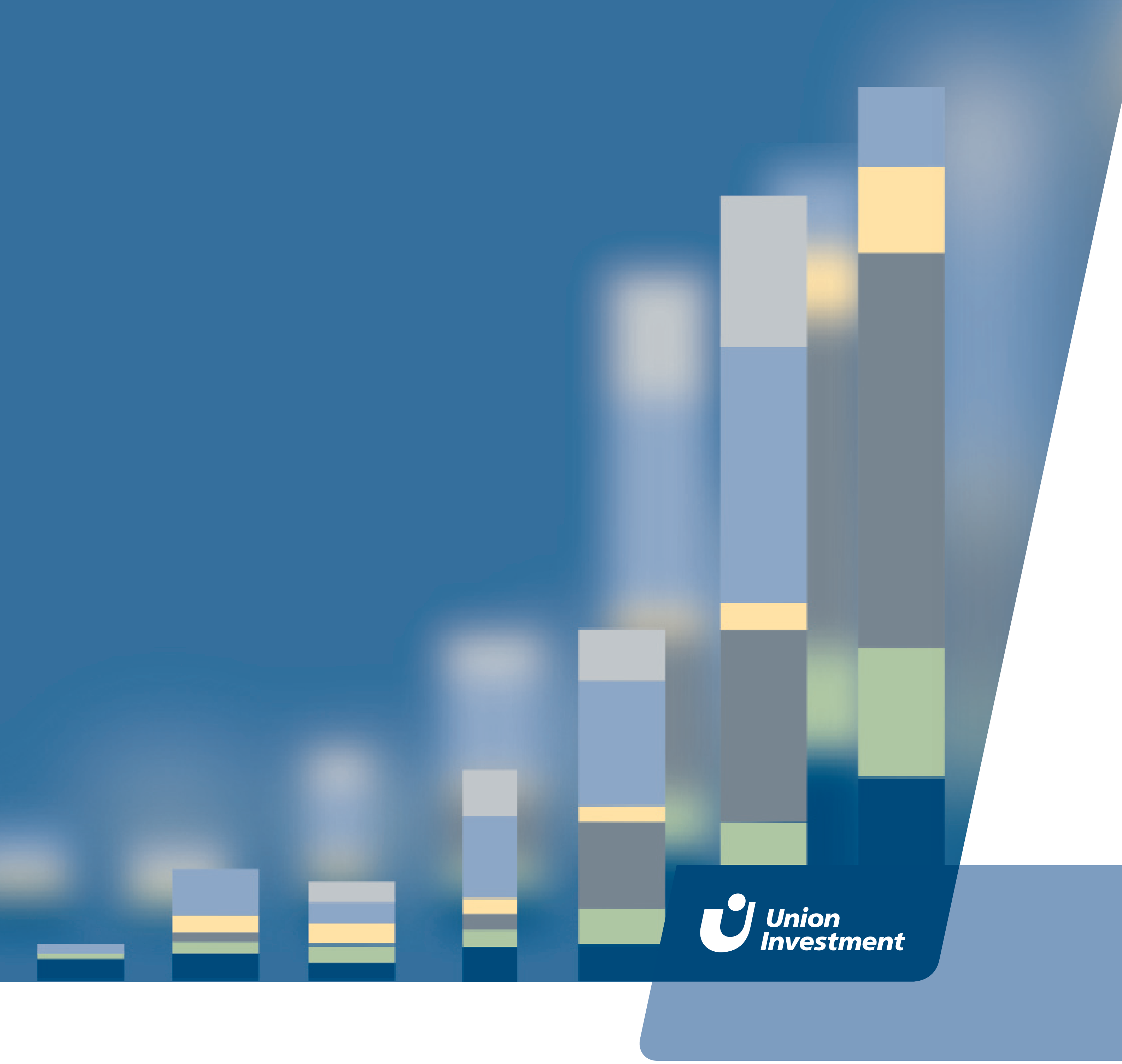


Taxonomy and green bonds

October 2019

1 Taxonomy – status report and relevance for green bonds

The recent European Parliament elections showed that support is surging for green political parties and a political agenda focused on sustainability. The change of thinking in environmental and climate policy appears to be gaining broader support. These topics are also becoming increasingly important to us, as investors, in shaping our activities. After all, the financial sector also has to play its part in working towards the Paris climate targets and the United Nations' sustainable development goals (SDGs).

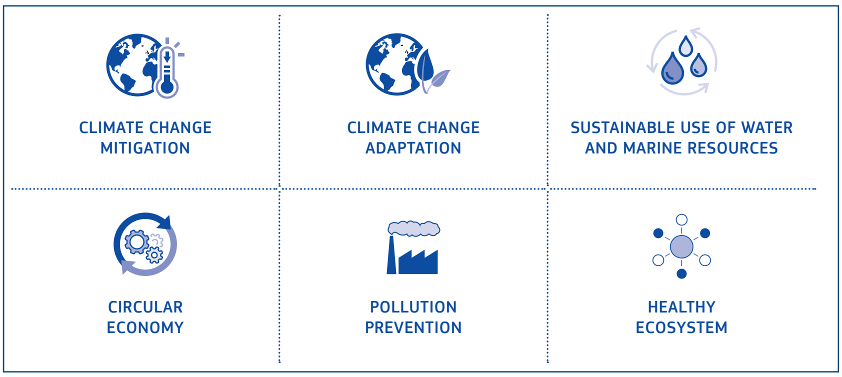
To guide the industry's efforts, planned changes to regulation at EU level are prescribing a framework for action. In June 2019, a technical expert group (TEG) set up by the EU Commission presented a proposal that defined a standardised classification system. This was known as the taxonomy report. It is intended to provide a transparent means of assessing the environmental impact of an activity or investment.

However, the taxonomy rules are just one part of the European Commission's wider strategy to encourage the capital markets to take greater account of sustainability. The broad-ranging objectives are set out in detail in an action plan on financing sustainable growth.

Scope of the taxonomy

Taxonomy in this context refers to the creation of an EU-wide standardised method for classifying sustainable economic activities. Six objectives have been identified for the taxonomy system.

Figure 1 **An EU-wide standardised system – taxonomy – for classifying sustainable economic activities**



Source: European Commission – Financing Sustainable Growth Factsheet

Due to the complexity of the issue, the TEG began by defining rules on climate protection ('Climate Change Mitigation', figure 1) and on adapting to climate change ('Climate Change Adaptation', figure 1). These rules can be used to identify sectors that have a particularly large, i.e. negative, emissions footprint – for example cement manufacturing – and to measure this footprint; However, they can also be used to identify sectors whose activities contribute to the reduction of emissions and therefore to the protection of the climate (e.g. renewable energies). The analysis of sector-specific activities is extremely nuanced – the consequences of establishing infrastructure for electric vehicles are taken into account, for example. This means that the impact can be analysed and quantified more precisely than ever before. But even if an activity is generally regarded as being climate-positive, it must not have unintended consequences that adversely affect any of the other five objectives. This is one of the reasons why the new taxonomy represents a substantial improvement on previous practice. Having a fixed set of rules, and therefore a more objective means of comparing activities, adds real value. At a later point in time, when the availability of data at company level has improved, the impact on the four other environmental objectives will also be analysed.

It's important to note that the taxonomy does not give any generally applicable definition of sustainability. The new taxonomy system is already helping to put together the first pieces of the puzzle, particularly in terms of the environment. But the wider and much more complex objective of sustainability is a puzzle that still has many of its pieces missing, as the focus has so far always been on climate-related KPIs. The intention is to close these gaps in the future through further projects and efforts to broaden the scope of the assessment.

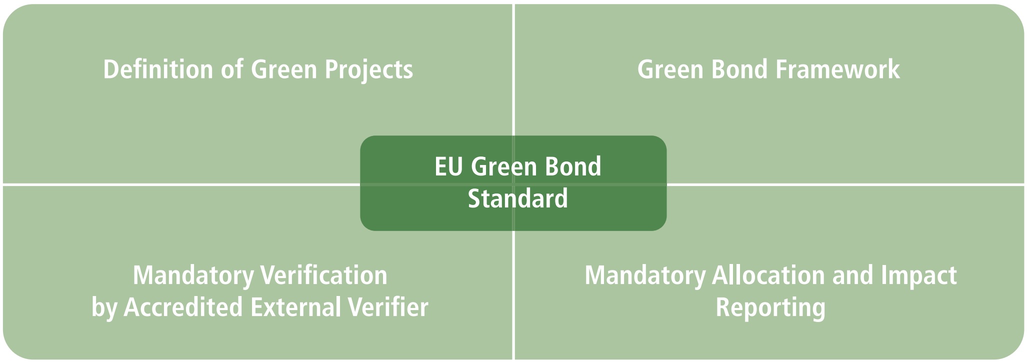
However, the taxonomy in its current form is ideal for application in one segment in particular – green bonds. The funds raised in this niche segment of the fixed-income sector are used to finance projects and investments with an explicit environmental focus, for which the necessary data is available.

Pioneering role for green bonds in the implementation of the proposed taxonomy

One of the initiatives under the EU action plan aims to establish a set of unified standards for environmentally sustainable financial products. The objective is to prevent 'greenwashing' and increase transparency. Green bonds represent the segment of the investment industry in which the taxonomy rules could be applied sensibly and without delay. The intention is for the EU Green Bond Standard (EU GBS), which builds on what the taxonomy has already achieved, to become the new market standard in this bond segment.

The benefits for investors are, as already outlined, recourse to fixed rules and standards, greater clarity as to how their funds will be used, improved documentation and an external and independent assessment process.

Figure 2 **Components of the EU Green Bond Standard (EU GBS)**



Source: EU Technical Expert Group on Sustainable Finance – Report on EU Green Bond Standard

To make it easier for issuers of green bonds to apply the rules, the comprehensive document on the GBS sets out a proposal for a standardised Green Bond Framework. It recommends that

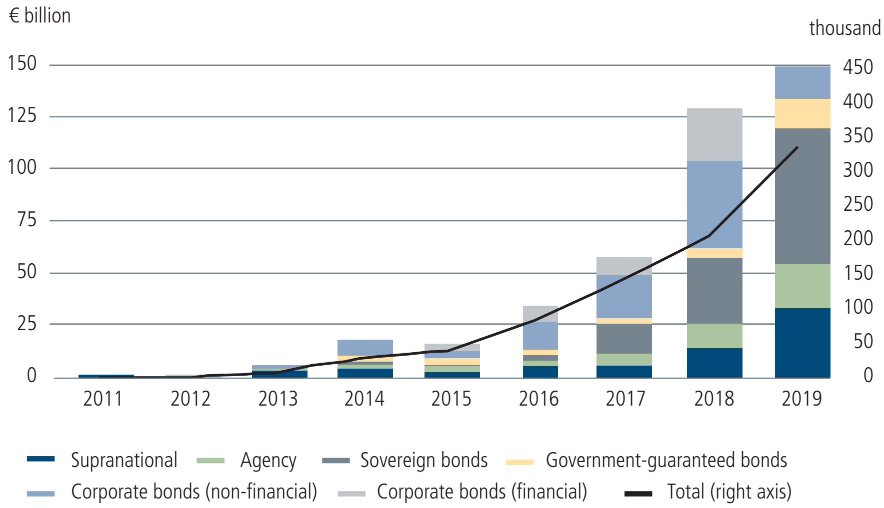
- the company's environmental goals are clearly defined;
- the bond positively affects at least one of the sustainable taxonomy objectives;
- the funded projects do not hinder the achievement of other taxonomy objectives;
- there is meticulous documentation of how the funds for the project will be used;
- the impact of the funded projects is measured;
- reporting is carried out even after the bond has been issued, and
- the bond's green credentials are externally verified by an officially accredited body.

One reason why the EU GBS stands a good chance of being a success is that institutional investors in particular will be more minded in future to increase the weighting of sustainable investments in their portfolios. New regulations could commit them to providing better and more detailed reports on their sustainable investments and the impact that these have.

Implications and practical implementation at Union Investment

It cannot yet be said with any certainty whether the taxonomy rules will help the green bond market to grow any faster than it already is. However, the more detailed and more transparent rules, together with the strong political imperative, will give investors even more reason to focus on this segment. We have already seen a sharp rise in the issuing volume of green bonds in recent years.

Figure 3 **Cumulative issuing volume of green bonds**



Source: EU Technical Expert Group on Sustainable Finance – Report on EU Green Bond Standard

These additional investment opportunities are part of the reason why the proportion of green bonds within our UniInstitutional Green Bonds fund has risen from around 51 per cent since the inception of the fund in 2017 to its current level of more than 90 per cent.

The new taxonomy is welcomed by Union Investment and will be used in the management of sustainable fixed-income funds. However, we do not expect that the existing fixed-income funds with a sustainability focus will need to be significantly adjusted. This is because the content of the new EU GBS is based not just on the new taxonomy but also on the green bond principles (GBP). Union Investment was involved in establishing these principles, and they were taken into account at the time when we were investing in bonds for sustainable funds and client portfolios. So the more precise rules set forth by the new GBS are unlikely to cause too many problems for the legacy holdings. Indeed Union Investment used – and is still using – ESG criteria alongside the green bond principles to assess fixed-income securities. Taken together, these provided a comprehensive assessment of individual bonds that is similar to the one now being proposed under the EU's GBS.

2 Conclusion and outlook

The taxonomy proposed by the European Commission's technical expert group is an important and necessary step. It will make it easier to compare the environmental implications of economic activity. Although the base data is still limited, a progressive broadening of available information will give investors even greater transparency and a more rounded picture of companies and their actions.

Green bonds, which form a sub-sector of the bond market, could already be sensibly classified with the help of the taxonomy rules and the new green bond standard. Clearer definitions, improved transparency, continuous documentation and an independent, external verification process will strengthen trust in the green bond segment. This should then lead to higher demand for the associated funds and portfolios – particularly from customers with a background in sustainability investment.

The new EU GBS could also serve as a framework for other 'green' financial products that might one day also bear a label proclaiming their climate-friendly credentials. The aim is to generate additional interest among investors for investment products that are constructed on this basis. The technical expert group is now looking for political support to drive acceptance of the new standards in the markets and to review their implementation.

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