

## REPORT & RECOMMENDATIONS

Following the meeting on 9 December 2020

The tripartite, independent High Level Group on Financing Sustainability Transition continued to ‘think outside-the-box’ on energy and financial aspects of the sustainability transition in the EU. This task was given to these temporary think tanks, set up following an initiative in the Competitiveness Council<sup>1</sup>. The High Level Groups are an ‘open innovation’ approach between governments, business and academia, to inject innovative policy ideas into the EU system<sup>2</sup>.

During its virtual meeting on 9 December 2020, the HLG evaluated past and future reforms in energy policy and finance, in particular **(I) the international dimension of sustainable finance and of the European Green Deal**, and **(II) beyond industry emissions: financing sustainability transition in the biosphere economy**. Recommendations are outlined for the attention of the European Commission, the European Council and the Council of the EU for their ongoing and future policy initiatives.

### I. The international dimension of sustainable finance and of the European Green Deal

Governments are developing ambitious sustainable finance policies and regulations in a growing number of countries. As industry value-chains, consumption patterns and GHG emissions are globally integrated, the EU Sustainable Finance policy and the effectiveness of its measures should be assessed in the light of international economic flows and global trade, and in comparison with other regulatory initiatives in non-EU countries. The HLG discussed: the effects of the EU Taxonomy on global trade (I.1); coherence between taxes, standards, labels and disclosures (I.2); applying EU circularity and sustainability principles to global value-chains (I.3).

#### I.1 The EU Taxonomy and global trade: how to avoid transition investment leakage?

Several countries have developed classification systems to identify environmentally sustainable economic activities, commonly referred to as ‘Taxonomies’. It is said that **the EU Taxonomy is one of the most advanced in the world**, for at least two reasons: it has a *general purpose*, which stands as a sustainability compass applicable for the entire financial system, whereas several other taxonomies are often restrained to specific green bond issuance or guidelines for green loans. The EU Taxonomy is also a very *inclusive system*, which integrates many different aspects of sustainability and which are tied together with the DNSH principle.

<sup>1</sup> Council of the EU, 5-6 December 2011, Presidency Note.

<sup>2</sup> Members participate in their personal capacity. All recommendations for action and all ideas for further consideration have not always been agreed on by all members, but advice is based on a very wide consensus. The final version is written under responsibility of the chairman and the secretary general.

**Beyond a mere guidance for green finance, the EU Taxonomy has been designed as a general investment prioritization tool broadly applicable to the real economy; it is therefore a very powerful system that can deliver considerable success, provided that it is adjusted accordingly.**

**To date, we observe an investment gap between the required industry transformations for sustainability, and the actually eligible amounts under the EU Taxonomy.** Research has shown that European capital markets offer very limited investment options that comply with the suggested technical screening criteria by the TEG<sup>3</sup>. The *binary approach* of the EU Taxonomy (green / non-green) excludes many potentially relevant activities, which still fail to qualify as green or transition activities despite an effective contribution to climate change mitigation. In addition, the ‘non-green activities’ are not necessarily equally exposed to climate-related financial risks. The EU Taxonomy therefore gives little guidance for the purpose of climate-risk mitigation.

**Taxonomies apply to a specific territory at national or regional level; however, they also have cross-border effects on global value-chains and trade.** Eligibility to the EU Taxonomy may contribute to promote EU standards and practices abroad, but it could also lead to diverging investment priorities with other jurisdictions, particularly in countries or continents less advanced in clean energy technologies and industry transition. Hence, the EU Taxonomy could fail to capture cross-border energy or industry investments with third countries, or fail to encourage substantial carbon emission reductions which could be achieved with a more relative approach (i.e. by incentivising progress on a scale from brown to green, taking into account the different starting positions between countries and regions).

**The question of the eligibility scope for investments under the EU Taxonomy is also a matter of competitiveness and innovation capabilities in the global race towards climate-neutrality.** For some, a too restrictive scope might indirectly create an *investment leakage* effect, in the sense that the EU Taxonomy would only reward the greenest activities (already Paris-aligned), thus leaving behind other potentially relevant investments that may be better incentivized and financed in other world’s regions. The transition towards a climate-neutral Europe requires innovation investments that should be incentivized within the EU, and this should be reflected as such in the EU framework for sustainable finance.

#### **Recommendations**

- **Adjustments could be made to improve the compatibility and coherence of the EU Taxonomy with other objectives set out under EU sectorial legislation and policies.**
  - In particular, attention should be paid to the specific targets in RED II (e.g. manufacture of biomass, biogas, biofuels), Energy Labelling (e.g. criteria based on absolute kWh values), rules for cars and vehicles, etc. so as to better calibrate the investment eligibility scope in coherence with other existing objectives at EU level.

<sup>3</sup> Adelphi/ISS ESG, *European Sustainable Finance Survey 2020*.

- It could be envisaged to distinguish between the requirements for “substantial contribution” to climate change mitigation (which may sometimes exceed other existing EU objectives), and the DNSH principle (which should be aligned with other existing EU objectives).
  - Depending on technical progress, the level of ambition in the EU Taxonomy could be increased progressively over time on a sector-per-sector basis, hence using the EU Taxonomy as a truly dynamic instrument.
- **The EU Taxonomy insufficiently reflects complex life cycle and cross-border supply chain management issues**, even more in the case of international intra-industry trade when it is complex to measure and validate eligibility criteria for investment projects (i.e. additionality of several criteria: origin of raw materials, production process, product usage). **Hence, it could be considered to avoid the additionality of eligibility criteria for certain activities**, such as intermediary products in energy and chemicals, as it is complex (if not impossible) and not always relevant to precisely monitor the environmental footprint throughout the entire chain. In some cases, investment eligibility could be more individualised so as to assess the real environmental benefits of an activity at its own scale.
  - **As a truly dynamic system is desirable to reflect technological change and innovation, it could be envisaged to carry out regular and targeted consultations with each industry sector**, so as to jointly identify fair and evidence-based technical screening criteria in their own individual sectors (e.g. pulp and paper, petrochemicals, electronic appliances, energy, transports, etc.), with periodic revisions (annual or biannual). This should be done in coordination with the activities of the Platform on Sustainable Finance. The proposed TSC would then be reviewed by the competent Commission’s DG(s) and updated accordingly.
  - **In order to incentivize companies to improve their environmental performance, the EU Taxonomy should not only recognize activities that already meet the criteria, but also recognize efforts with the purpose of meeting those criteria over time.** The financing of improvement measures for an activity to become Taxonomy-aligned (i.e. through CAPEX and, if relevant, OPEX) could be eligible if they are part of an implementation plan to meet the activity threshold over a defined period of time as suggested by the TEG in its final report.<sup>4</sup>

<sup>4</sup> A full analysis is given in the Summary Report (Section 2.1.3 - Improvement measures within an economic activity, p. 15).

- **There is a need for further global harmonisation between taxonomies, which would help international financial flows allocated to transition investments and the scaling up of sustainable finance at global level.** When taken up at the global level<sup>5</sup>, the classification exercise of sustainable economic activities would need to be **more granular and progressive** ('from brown to green', with several shades of green and brown) so as to better reflect transition efforts between countries and continents with very different starting positions. The EU does not have to wait for the slowest mover or accept the lowest common denominator, given its market size.

## I.2 Coherence between taxes, standards, labels and disclosures

The HLG has already discussed the possible design and effects of **carbon border taxation**. Although various views were expressed, there was a large acknowledgment on the need for a fully dynamic, evidence-based and constantly adjusted system, WTO-compatible, and effectively enabling a cost pass-through effect along the value-chain (rather than penalising one single point of production). Carbon taxation should result in a relative differentiation of prices for consumers, hence creating an incentivising market for sustainable goods. In this regard, the VAT instrument was identified as a possible good candidate and more attention and creativity should be paid by the Commission to its practical feasibility.

There is a need for international harmonisation of **standards and labels for green and sustainable financial products**, such as green bonds and securities, green loans, but also mixed/blended finance applied to industry transition investments. The aim would be to facilitate the global scaling-up of sustainable finance by enabling further coherence across countries and continents. Currently, the green bond market represents only 3.7% of total global bond issuance, making it difficult to ask market participants to build green portfolios<sup>6</sup>.

In many countries, governments have increased the level of legal obligations on **climate-related disclosures**, hence providing investors with greater visibility on climate risks associated to the business in which they invest. However, only a few jurisdictions (such as the EU and China) have developed a *double-materiality perspective* in disclosure rules, i.e. covering both the *financial materiality* (impacts of climate change on the company, e.g. SASB standards) and the *environmental materiality* (impacts of the company on climate change).

<sup>5</sup> Harmonisation could be facilitated in the framework of the International Platform on Sustainable Finance (IPSF), which already foresees a Common Ground Taxonomy as a "unique common reference point" for the identification of investments that are eligible in all existing IPSF Taxonomies (IPSF, *First Annual Report*, October 2020).

<sup>6</sup> S&P Global, *The EU Recovery Plan Could Create Its Own Green Safe Asset*, 15 July 2020.

### Recommendations

- **A system of carbon taxes or green VAT should enable a level-playing field between imported finished goods and domestic (EU manufactured) finished goods**, since the latter may be penalised assuming that imported finished goods may be manufactured with cheaper and carbon-intensive raw materials. **Likewise, this system could incentivise sustainability efforts in third countries for products entering the EU market**, such as sustainable and deforestation-free agriculture in Latin America, Africa or Asia.
- **The EU could become the main liquidity provider for a green safe asset with long duration, by financing a large share of its €750 billion recovery fund through green bond issuance.** This would help respond to a fast-growing ESG investor base and increase the size of the global green bond market, while also enhancing the attractiveness of the European marketplace for sustainable finance.
- **Sustainability-linked bonds**, for which returns are linked to issuers' performance on pre-defined climate indicators, **can effectively incentivise the gradual progression on a scale from brown to green**, rather than simply rewarding the greenest products. It can also stimulate an effective decarbonisation progression in all countries, regardless of the various starting situations. **The use of the voluntary sustainability-linked bond principles<sup>7</sup> should be further encouraged by the EU** (e.g. via a common standard and regulatory incentives), in parallel to the green bond standard.
- **In terms of climate-related disclosures**, the right balance needs to be found between general reporting harmonisation and sector-specific reporting, while also taking into consideration the proportionality of legal obligations, in particular for SMEs. This could be done by achieving a **minimum level of common reporting obligations** (as part of the revised NFRD<sup>8</sup>, e.g. general but common ESG KPIs), together with the development of **sector-specific reporting tools**. There is also a need to **further harmonise the environmental materiality of disclosures** (i.e. impacts of a company on climate change), so as to improve its effects on investors and consumers' choice.

### I.3 Applying circularity and sustainability principles to global industry value-chains

**International trade is impacted by many pieces of EU regulation related to climate.** Typically, legal sustainability requirements for product design and manufacturing apply both to domestic goods (EU manufactured) and foreign goods (imported) when they enter the single market. Such is the case of many EU Regulations and Directives falling under the scope of the EU harmonisation framework (Art. 114 TFUE), e.g. Ecodesign Directive, Packaging & Packaging Waste Directive, the upcoming Sustainable Product Policy Framework, EU phytosanitary standards, etc. **Such measures can *de facto* stand as non-tariff barriers to unsustainable trade.**

<sup>7</sup> ICMA, Sustainability-linked bond principles, voluntary process guidelines, June 2020.

<sup>8</sup> Non-Financial Reporting Directive, 2014/95.

In the current context of a weakened WTO and unpredictable multilateral relations, **the EU should make a more strategic use of its bilateral trade relations, in terms of sustainability and circularity.** The EU should link this approach with **aid and development policies** and offer technical support to least developed countries to upgrade their production capabilities in order to avoid export disturbances with dire economic and social consequences.

**As the European economy will become greener and more circular, the quantity of new (primary) critical raw materials entering the EU market will decrease.** Regulatory measures such as MLRC (Minimum Levels of Recycled Content) for scarce raw materials in batteries or in cars will require manufacturers to increase the share of secondary raw materials within their products, which may in turn increase Europe's trade independence from the rest of the world. This will be in line with the objective of achieving more European strategic autonomy.

### Recommendations

- **As it is desirable to create a global regulatory level playing field for green products,** rather than a patchwork of incompatible regional green markets, **the EU should seek to pursue international harmonisation in the legal technical requirements related to sustainability.** This could be achieved in particular via the international standardisation bodies (ISO, IEC, ITU) and the strong European presence within them (CEN, CENELEC, ETSI)<sup>9</sup>. The EU has all it takes (industrial potential, R&D and innovation ecosystems, trade and diplomatic soft-power) to shape the technical standards of the green economy and to export its best practices to other regulatory systems.
- **Comprehensive trade agreements such as the CETA could be seen as models to strive for more regulatory coherence and political cooperation among governments, with a stronger focus on sustainability.** For example, the EU could seek to promote its sustainable forest management model with African and Latin American partners. Bilateral political cooperation will not only facilitate global trade for sustainable products; it will also offer competitive advantages to cooperating countries against those with lower environmental standards. Compliance with globally recognised sustainable requirements will become an asset for market access.
- **It is of strategic importance for the EU to further invest into its secondary raw material economy and recycling infrastructures,** so as to become able to process locally a larger part of recycled goods and materials, in all sectors.

<sup>9</sup> European Standardisation System, EU Regulation 1025/2012.

## II. Beyond industry emissions: financing sustainability transition in the biosphere economy

Until now, the HLG has considered sustainable finance mainly from an industry and energy perspective. Yet, climate change is the result of a mix of emissions. Political attention is often focused on industry emissions, and not enough on agriculture and land use emissions, although they represent approximately 10% of EU GHG emissions and 25% of global GHG emissions. They emerge mainly from agri-food industry processes (meat, livestock, animal products). A balanced approach towards climate-neutrality should focus on the joint efforts of all major GHG emitters, depending on their actual decarbonisation capabilities.

### II.1 Sustainability objectives in the EU ‘Farm to Fork’ Strategy

In May 2020, the European Commission launched its **Farm to Fork Strategy (F2F)**, an **integral part of its goal to make Europe the first climate-neutral continent by 2050**. The F2F strategy *“addresses comprehensively the challenges of sustainable food systems and recognises the inextricable links between healthy people, the healthy societies and a healthy planet”* and *“lies at the heart of the Green Deal”*.

**The Commission’s main tool for achieving these goals is the EU Common Agricultural Policy (CAP)**, currently up for renewal for the 2021-2027 period. The new CAP has a proposed annual budget of €48 billion (one third of the total Multiannual Financial Framework) administered through direct support payments (Pillar I), and financing for rural development (Pillar II). It provides a new greening framework, in line with the F2F goals. For example, the Commission has proposed a 20% share of total Pillar I direct payments for ‘eco-schemes’ or sustainability projects. However, proposed amendments to the CAP risk that the legislative framework will become decoupled from the green ambitions in the F2F strategy, thus hindering the overall objectives of the Green Deal which should be pursued in a fair and equitable way by all emitting sectors.

### II.2 Pricing externalities and carbon farming

**The in-pricing of externalities is a critical success factor for the transformation of the food system to a climate smart and regenerative model.** There are a growing number of projects around the world experimenting with ways to price externalities into food systems, including raising value added taxes on unhealthy foods, paying farmers to manage the countryside, and providing financial incentives to increase the health of the soil.

Within the agricultural sector, **livestock farming** (cattle in particular) is the largest source of land conversion, so initiatives focusing on cattle farmers are of particular interest. **Carbon farming**, i.e. paying farmers to sequester carbon by not converting or reconverting land to carbon sinks, is regarded as a very promising initiative as it **creates new revenue streams for farmers**.

EU farmers are part of a **global food and agriculture system** that favours efficiency and scale. Product commoditization and a lack of pre-competitive organizational power have left primary producers with little control over their earning capacity in a system in which economic equality is not evenly distributed. Therefore, **many food producers will be reluctant to embrace change as long as they are focused on surviving in an international production environment characterized by high volatility in demand, downward pressure on prices and tight margins.**

### II.3 Investing in research and innovation

As with other sectors, **new technologies and innovation will play an important role in transitioning the agricultural sector to more sustainable production methods.** The Commission's targets of reducing the use of synthetic plant protection products (PPPs) and fertilizers will depend on the development of alternative bio-based products and/or the large-scale adoption of precision agricultural practices (data-driven, targeted application of PPPs and fertilizers in precise quantities).

While there has been considerable research into **integrated pest management systems** (a combination of land use, genotyping, developing bio-based products and early warning monitoring systems) and **bio-based circular nutrient programs**, we are still a long way from being able to substitute these methods for traditional methods without compromising output capacity.

**Organic farming**, which excludes the use of synthetic inputs and is targeted to grow to 25% of Utilized Agricultural Area (UAA) under the F2F strategy, also faces challenges in terms of controversial inputs, such as copper fungicides. Modelling shows the potential for reducing GHG emissions from enteric fermentation by making **changes to livestock feed** is frustrated by the high costs of current adaptations. Increasing research and innovation in emerging alternatives could deliver significant returns on investment.

### II.4 Targeted subsidies, blended finance, and de-risking

**For farmers interested in investing in more sustainable business models, the prospect of having to make significant investments in production technologies and/or land use can form substantial barriers.** As many sustainability investments are "asset light" with long-term returns, financial institutions are often wary about making commitments in a low-margin industry with high levels of price volatility.

**Tying agricultural subsidies to "greening" projects** has been tried in various projects throughout the EU under the aegis of CAP and national subsidies. For example, in the UK and France, the government has targeted subsidies for reducing synthetic inputs such as pesticides. Projects using **blended financing** where national governments (soft money/de-risking) collaborate with commercial financiers (loans), research institutions (KPIs & metrics) and NGOs (monitoring & evaluation) to achieve environmental, social and economic goals have shown promise. The idea of **raising barriers/costs to brown investments** in the agri-food sector could also be envisaged, e.g. based on the EU Taxonomy.



## II.5 Reducing food loss and waste

Food loss and waste accounts for 6% of total EU GHG emissions. The Commission is committed to reducing food loss and waste by 50% by 2030. **The investment case for reducing food loss and waste is attractive in terms of potential environmental and economic returns, as well as the speed at which they can be achieved.** Relatively simple and easy to implement measures can have a significant impact on reducing food waste, such as removing confusion between “best-before” and “consume before” labelling.

## II.6 Way forward

### Recommendations

The CAP has created and sustained the current food system, but it will have to play the key role in making it more sustainable too. The new CAP for the 2021-2027 can be placed in the continuing line of evolution of the policy framework. It breaks important ground in making environmental sustainability a key topic of discussion. However, key structural characteristics from the current CAP remain in place and it is hard to see how it will stimulate the systemic changes outlined in the F2F strategy. If the CAP is to instigate more radical change, then key structural elements will need to be transformed:

1. **Orientation.** Pillar 1 support should move from area-based payments towards the targeted provision of public goods in the form of specific health, environmental, social and economic outcomes. Current CAP proposals for the 2021-2027 period make an important shift from being process-based to result-based, stipulating desired outcomes and giving Member States and farmers the flexibility to come up with appropriate interventions to achieve them. However, the primary outcome for much of CAP financing remains income support. Gradually shifting the primary focus to the provision of public goods such as climate mitigation, ecosystem services and animal welfare, but also nutrition, and economic and social equity outcomes can provide a framework capable of supporting a more balanced systemic transformation in line with the F2F strategy ambitions. Public finances will continue to support the farmers' income, but they must be linked to public benefits.

2. **Scope.** The F2F strategy aims to transform the entire EU food system. Yet, the CAP focuses on only one part of the food value chain: food production. Major scientific studies<sup>10</sup> on the transformation of food systems to more sustainable pathways are unanimous in their conclusions that shifting consumption patterns to healthier, more sustainable diets are a critical component of these transformations. Similarly, reducing food loss and waste throughout the food value chain is considered as an essential component of transforming food systems. The Commission recognizes both dietary changes and the reduction of food/loss waste as key objectives of the F2F strategy. However, both these key transformation vectors fall largely outside the remit of the CAP. They should be targeted in the CAP framework either as specific objectives or strict conditions linked to Statutory Management Regulations.
3. **Transformational capacity.** Achieving the F2F strategy objectives will require consumers to change their eating habits. However, these changes pale in comparison to the demands for change that are being placed on primary producers. Helping farmers to adapt to new business models and production methods will be essential if we are to have any hope of a smooth and swift transition. Investments in four key areas will increase the transformational capacity of food producers:
  - a. **Training and knowledge sharing.** The CAP should put more emphasis on advisory services and training through programs such as Agricultural Knowledge and Innovation Systems (AKIS) and EIP-Agri, perhaps through making them mandatory for certain levels of direct financial support.
  - b. **Research and Innovation.** Technology will play a key role in helping farmers to move away from production practices with negative environmental and climate impacts, such as the (over)use of synthetic inputs. Financial support for programs such as Horizon Europe will need to increase far beyond current levels. We need an ‘Operation Warp Speed’ for the agricultural sector.
  - c. **Clear targets and indicators.** Farmers need clear, easily understood and consistently applied targets and measurement processes if they are to make long-term investments in transforming their production methods and business models. The CAP needs to invest in helping farmers adopt measurement technologies based on agreed standards to help them adapt.
  - d. **Level playing field.** The EU farm system is part of a global system and it should not lead to negative externalities, in particular not in developing countries. If EU farmers are to adapt to new sustainable methods of production and climate-smart business models, then they will need to be assured that their products will be not simply replaced in EU consumer baskets by cheaper products from producers operating under less stringent environmental, social and health standards outside the EU.

<sup>10</sup> See for example the World Resource Institute (2018). Global Report. “Creating a Sustainable Food Future”, or the Food and Land Use Coalition (2019). Global Report. “Growing Better”.

**4. Financial innovation.** The EU has made the first tentative steps into a new realm of finance with the pending launch of the NextGenerationEU initiative to help Member States recover from the COVID crisis. The first glimmer of new possibilities for EU common debt instruments combined with the growing appetite of financial markets for green bonds should be examined for their potential to compliment or even replace key aspects of future CAP financing. In doing so, attention should be given to possibilities for strengthening collaboration with the private sector along the entire food value chain as well as the financial sector.

25 January 2021