POLICY RESEARCH

# EU Taxonomy of Sustainable Activities

## Communicating to investors in a common language moves a step closer, but national authorities, large corporations, and collective investment funds face challenges compiling the new data.

**Manager Research EMEA**
1 June 2020

Andy Pettit
Director, Policy Research (EMEA)
+44 203 107 0029
andy.pettit@morningstar.com

Tim Walton
Data Director
+44 203 107 0080
tim.walton@morningstar.com

### Executive Summary

The final report of the EU Technical Expert Group,[1] published in March 2020, provides those entities that are required to use the EU Taxonomy with much of the information they need to get prepared. National authorities, large corporations, and environmentally focused investment funds are all charged with measuring and informing investors how they align with the taxonomy.

There's no doubt the taxonomy is an ambitious project and will be instrumental in providing advisers and investors with new, more focused, more consistent insights to the environmental credentials and ambitions of the issuers they consider investing in.

The effects of the taxonomy regulation will materialise gradually as the scope continues to get rounded out between now and full implementation at the end of 2022. This gives rise to some timing challenges, particularly for investment products, where disclosure requirements will kick in before some of the upstream information is required by and available from companies.

The initial incarnation is entirely focused on positive 'green' activities and will go a long way to normalise the information available about positive changes that companies and investment products are achieving. As a result, the environmental ambitions of these products will have to be substantiated and thereby minimise the scope to exaggerate green credentials (so-called greenwashing).

The regulation also contains an important review clause allowing for potential expansion to cover 'brown' activities that do significant harm to the environment and therefore, by elimination, a final set of activities that are 'neutral' –that is, they neither do significant harm nor have a significant role in meeting the objectives of the taxonomy. This would be a welcome development to help investors

1. https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/200309-sustainable-finance-teg-final-report-taxonomy_en.pdf

distinguish between those companies that are contributing but doing no significant harm; those not contributing but also not doing harm; and those that are causing significant harm.

An element of nonaligned taxonomy investment will remain for most products because the taxonomy reporting obligations fall upon the largest companies only. Thus, to start with, there is only a hope, rather than an expectation, that smaller firms will voluntarily adopt some level of taxonomy-based disclosure or that the scope of applicability will be expanded, or a 'taxonomy-lite' version will be introduced for small and medium-sized firms.

In this paper we concentrate primarily on interpreting the key measures that companies and investment products will have to identify, monitor, and report, based upon the currently available draft regulation and final report of the Technical Expert Group. The myriad other ESG disclosure obligations embedded across multiple other pieces of regulation will be covered in a dedicated sister report.

## Key Takeaways

- Companies will provide most insight by showing their degree of taxonomy alignment from the perspective of both turnover and expenditure:
  - Turnover will illustrate the extent to which a company's undertakings are already aligned (current situation).
  - Expenditure will show how much a business is spending to become more aligned (direction of travel).

- Requirements for companies and financial products are imperfectly, but not insurmountably, aligned:
  - Financial products will be required to complete their first set of disclosures against the taxonomy by the end of 2021, whereas company reporting will only commence in 2022.
  - Companies are only recommended to disclose certain breakdowns that financial products investing in those companies are required to disclose, such as the proportion of taxonomy activities across each of the six objectives.
  - Financial products will be invested in many companies that are not obliged to report taxonomy alignment.

- A wealth of new information will be available to advisers and investors. Its full value will depend heavily on how well it is presented and explained by companies and financial products.

- Products face significant, and valuable, new measurement and reporting obligations, and whether they can fulfil them without reversing the overall downward trend in fund fees remains to be seen.

- The financial products that are not obligated to make taxonomy disclosures are required to publish a disclaimer that 'the investment(s) underlying this financial product do not take into account the EU criteria for environmentally sustainable investments.' Investors should not assume that a product's holdings are not taxonomy-aligned. It might equally mean that while the product does not pursue ESG as a core goal, some of its holdings may be highly taxonomy-aligned.

## Background

One hundred ninety-six countries, and the EU itself, are now signatories[2] to the 2016 Paris Agreement on climate. The governments of many of those countries are increasingly turning to their financial-services sectors to help fulfill their commitments.

To put some context around the scale of the task, the EU estimates a yearly investment gap of EUR 175 billion-EUR 290 billion to meet its envisaged target of a 50% cut in greenhouse gas emissions by 2030 and to be climate-neutral by 2050.[3]

The EU taxonomy is designed to identify company activities that are aligned to this goal and is a core component of a major EU project to leverage financial markets to address sustainability challenges—particularly global warming—complete with new legislation and directives that are in various phases of development.

### Interest from Investors Continues to Increase

In 2019, 76 climate-aware funds came to market, following 67 new launches in 2018. The decarbonization type of strategy, including low carbon and ex fossil fuel, has seen the highest number of new launches.

Climate-aware funds represent a broad range of approaches that aim to meet varying investor needs and preferences. Flows into funds that specifically market themselves as climate funds have increased in recent years, with a major uptick in 2019. Around EUR 12 billion was invested into these products last year, driven mainly by growing investor interest in climate issues.

Asset managers have responded to this dynamic by launching a growing number of climate-aware funds and amending existing strategies to incorporate climate change objectives such as lower carbon footprint, reduced exposure to fossil fuels, and greater exposure to renewable energy opportunities.

Climate solutions and green bond funds have been the most popular strategies. A recent Morningstar Report, ‘Investing in Times of Climate Change,’ identified 405 climate-related funds.That paper takes a deep dive into those 405 funds, examines their involvement in fossil fuels and the like, and looks under the bonnet at their most common holdings.

2. http://worldpopulationreview.com/countries/paris-climate-agreement-countries/
3. EU Green Deal: https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal_en

**The European Commission's Sustainable Finance Action Plan**

The EU's efforts are guided by the Sustainable Finance Action Plan, the European Commission's proposed package of new laws and regulations that aims to elevate the environmental and social sustainability of an enterprise as a key factor for investors. Political agreement and much of the legislative text were largely complete by late 2019, with work on the detailed implementing measures continuing through 2020.[4]

The Taxonomy Regulation is in many ways the cornerstone of the package. The political agreement reached at the end of 2019 created a legal basis for its framework and for the parties that will be subject to elements of the regulation.

While the detailed implementation rules will be set later in 2020 and 2021, the final report of the Technical Expert Group will be the foundation of those delegated acts. That report forms the foundation of this paper, in which we seek to illuminate the requirements imposed on different actors and how they might be fulfilled whilst also highlighting some areas that will benefit from further guidance or clarifications.

## Key Features of the Taxonomy

At its core, the taxonomy is essentially a defined set of activities that are deemed to make substantial contributions to environmental objectives and thereby help to finance the transition to a more sustainable economy.

The Taxonomy Regulation[5] imposes measurement and reporting obligations on corporations, financial products, and government bodies and is closely linked with other EU regulations, most notably the Sustainability-related Disclosures Regulation.

Six environmental objectives are defined by the Taxonomy: climate change mitigation; climate change adaptation; water and marine resources; circular economy; pollution prevention and control; and biodiversity and ecosystems.

Activities that are aligned to one or more of the six objectives may either substantially contribute to environmental performance of industry directly or act as an enabling or transition activity.[6] Direct activities are those performed in an environmentally sustainable manner and taxonomy-aligned in their own right, enabling activities are products or services that enable other activities to make a substantial contribution. Transition activities are those where there is no technological and economically feasible low carbon alternative, and it supports the transition to a climate-neutral economy.

4. Under the EU legislative process, once the Commission adopts a proposal for a regulation, the Parliament and Council separately consider their views before entering into trialogue negotiations. Once agreed and adopted by both institutions, the Commission will publish the text in the Official Journal, to take effect usually 12-18 months later.
5. Regulation on the establishment of a framework to facilitate sustainable investment (Taxonomy Regulation).
6. Full details of Direct, Enabling, and Transition can be found in Articles 3, 6(1)(i) [11a] and 6(1)(a) of the Taxonomy Regulation, respectively.

The March 2020 final report by the TEG recommends eligible activities and associated screening criteria towards the first two objectives. It should be noted that the initial screening criteria set a baseline, and for certain activities the criteria are likely to be tightened over time. The criteria leave no shade of grey, acting as stark pass/fail metrics for companies. That is to say, an activity as performed by a company either meets the criteria or not, and if not, it cannot claim any degree of taxonomy alignment with regard to that particular activity.

To be taxonomy-compliant, beyond making a significant contribution to one of the six objectives, that activity must also do no significant harm (DNSH) to any of the other five and also meet minimum safeguards on workers' and human rights.[7]

The key milestones in the ongoing rollout of the taxonomy and its downstream adoption are shown in Exhibit 1.

**Exhibit 1** EU Taxonomy: Timetable

| | |
|---|---|
| Political agreement reached on Taxonomy Regulation | 18-Dec-19 |
| Taxonomy Regulation written into the Official Journal | ETA Jun 2020 |
| Final Report of the Technical Expert Group | 9-Mar-20 |
| Newly established 'Platform on Sustainable Finance' and 'Member State Expert Group' to provide ongoing guidance to the Commission as it manages the future development of the taxonomy | 31-Dec-20 |
| Delegated Act specifying how the corporate disclosure requirements should be applied in practice, by both financial and non-financial companies—Adopted | 30-Jun-21 |
| Delegated Acts with technical screening criteria for climate change objectives<br>Adopted<br>Effective | <br>31-Dec-20<br>31-Dec-22 |
| Company disclosures related to climate commence for 2021 financial year | 31-Dec-21 |
| Financial product disclosures related to climate commence | 31-Dec-21 |
| Delegated Acts with technical screening criteria for the other four objectives<br>Adopted<br>Effective | <br>31-Dec-21<br>31-Dec-22 |
| Commission review of verification and assurance requirements | 2022 |
| Company disclosures related to all objectives commence for 2022 financial year | 31-Dec-22 |
| Financial product disclosures related to all objectives commence | 31-Dec-22 |

Source: Morningstar. Data as of 28 April 2020.

7. Article 13 of the Taxonomy Regulation comprises the standards embedded in the OECD Guidelines on Multinational Enterprises (MNEs) and the UN Guiding Principles on Business and Human Rights, with specific reference to the ILO Core Labour Conventions.

**The Taxonomy and Corporations**

Corporations are at the heart of the taxonomy in terms of identifying, measuring, and divulging the elements of their activities that comply with it. Firms covered by the Non-Financial Reporting Directive, generally large public companies with more than 500 employees, plus banks and insurers, will need to report the degree to which their business activities align with the taxonomy.

Because of the nature of international markets and supply chains, the taxonomy will have implications beyond the EU. While some of the screening criteria are internationally relevant, it's acknowledged that other activities may have locally relevant standards that may be reasonably applied.

Ultimately, a wealth of new data will enable investors to explore the composition of businesses through an environmental lens–or rather lenses, because the business will be sliced and diced from multiple angles, as we explore in the next section.

**A Raft of New Measures for Investors**

On the surface, identifying the projects and products across a business that are taxonomy-aligned and then adding up the amount spent and turnover associated with them sounds reasonably straightforward. Unsurprisingly, though, the 'devil is in the details' idiom quickly kicks in.

Activities must be assessed against the DNSH and minimum safeguards criteria to ensure they are eligible to be counted. If it passes these tests, then each activity will need to be assessed against the technical screening criteria, if they are available. In some cases, the activity may have a low environmental footprint and thus has not yet had criteria developed. In other cases, the activity may contribute to one of the four objectives for which criteria will not be developed until late 2022.

Each activity or asset might align to more than one taxonomy objective. To avoid double-counting, firms must decide which objective they will assign them to. It's most likely to be the objective for which the percentage of turnover is highest, though companies can elect on any basis and are encouraged to report if the activity or asset also contributes to other objectives.

Having got this far, the calculations can begin, and there could be a lot of them. Disappointingly, as shown in Exhibit 2, the TEG recommends rather than mandates many of them, which will almost certainly hinder comparability as different companies disclose different levels of detail.

**Exhibit 2** Summary of Taxonomy Calculation and Disclosure Requirements

| Goal | NFRD Companies | Non-NFRD Companies | Sustainable Financial Products | Other Financial Products | EU Green Bonds | Other Green Bonds | Corporate Bonds | Sovereign Bonds |
|---|---|---|---|---|---|---|---|---|
| Taxonomy alignment total (turnover) | Must | Ideally | Must | C or E | N/A | N/A | N/A | N/A |
| Taxonomy alignment total (capex) | Must | Ideally | Must | C or E | Auto | Ideally | Co | TBA |
| Aligment by each of the 6 objectives | Ideally | Ideally | Must | C or E | Must | Ideally | Co | TBA |
| Alignment by own, enabling, and transition activities | Ideally | Ideally | Must | C or E | Must | Ideally | Co | TBA |
| Potential alignment | N/A | N/A | Ideally | C or E | N/A | N/A | N/A | N/A |

Source: Morningstar. Data as of 28 April 2020.
**Ideally**=recommended; **C or E**=comply or explain; **Co**=estimated based on issuing company data; **Auto**=100% aligned.

The level of taxonomy alignment should be calculated based on turnover (defined as total revenue over a specific period); on capital expenditure; and, in some cases, on operational expenditure. Each measure will give different insights into a company, with turnover illustrating the extent to which a company's undertakings are already aligned (current situation) and capital expenditure showing how much a business is spending to become more aligned (direction of travel).

However, calculations will differ depending on the environmental objective being pursued and the manner of pursuit (equity or debt). For example, turnover can be attributed to climate change adaptation activities only if it relates to an enabling activity.

The result is that companies must report their total level of alignment with taxonomy objectives and may report on the proportion aligned with each of the six objectives, an example of which is illustrated in Exhibit 3a. Further, particularly in the case of climate change mitigation activities, they are encouraged to provide turnover or capital expenditure broken down to the level of transition and enabling activities.

**Exhibit 3a** An Example of a Company Taxonomy Alignment Report: Activity Breakdown

| | **Company Activities** | | | | | |
|---|---|---|---|---|---|---|
| Climate Change Activity | 1 | 2 | 3[A] | 4 | 5[B] | Other[C] |
| **Total Mitigation** | **20%** | **15%** | **10%** | — | — | — |
| Substantial Contribution | 20% | — | — | — | — | — |
| Enabling | — | 15% | — | — | — | — |
| Transition | — | — | 10% | — | — | — |
| **Total Adaptation** | — | **15%** | — | **5%** | — | — |
| Substantial Contribution | — | — | — | — | — | — |
| Enabling | — | 15% | — | 5% | — | — |
| Transition | — | — | — | — | — | — |
| **Total Overall Alignment** | **20%** | **15%**[D] | **10%** | **5%** | **60%** | **5%** |

Source: Morningstar. Data as of 28 April 2020.
[A] Activity listed in taxonomy but no screening rules. [B] Do not meet criteria to any extent. [C] Not listed in Taxonomy
[D] Where an activity contributes to more than 1 objective, choose only one (Mitigation chosen for activity 2).

Exhibit 3a shows the activities of a hypothetical company, four of which correspond to activities named in the taxonomy. For the purposes of clarity, the example results used are higher than we expect to see in the early years of reporting. The turnover of activities 1 and 3 are aligned with climate mitigation and shown as a proportion of total company turnover associated with the activity. Activity 2 meets the criteria for both the mitigation and adaptation objectives.

Activity 4 is listed in the taxonomy but without any specific screening criteria as yet, and as such it is by default deemed to be aligned. Activity 5 is also a taxonomy activity, but it either does not satisfy any of the screening criteria or, if it does, it is not attributable because it fails the DNSH or safeguard tests. None of the company's other activities are taxonomy-defined. Activity 6 is not one that is included in the taxonomy and therefore cannot contribute towards the company's taxonomy alignment.

Total turnover aligned to mitigation and adaption objectives is shown beneath the activity breakdown, and the last table shows the company's overall proportion of taxonomy alignment. Here it is crucial to avoid double-counting, and so in this example activities have been assigned to the objective to which they contribute the most turnover.

The example in Exhibit 3b illustrates the position as it will be during the first year of company reporting in 2022. The breakdowns will be multiplied in subsequent years as the other four taxonomy objectives come on stream.

Exhibit 3c shows the consolidated position, where the degree of alignment due to enabling activities reflects the elimination of double-counting by including only the contribution made via climate mitigation activities.

**Exhibit 3b** An Example of a Company Taxonomy Alignment Report: Objective Breakdown

| | **Sum of All Activities:** Overall and by Type | | | |
|---|---|---|---|---|
| | Total | Substantial | Enabling | Transition |
| Mitigation | 45% | 20% | 15% | 10% |
| Adaptation | 20% | 0% | 20% | 0%[A] |

Source: Morningstar. Data as of 28 April 2020.
[A] Only turnover associated with enabling activities can be counted for adaptation.

**Exhibit 3c** An Example of a Company Taxonomy Alignment Report: Overall Alignment

| | |
|---|---|
| % Covered by Taxonomy | =100% – 5% = 95% |
| % Taxonomy Aligned | = 20% + 15%[A] + 10% + 5% = 50% |
| % Substantial Contribution | = 20% |
| % Enabling | = 15%[A] + 5% = 20% |
| % Transition | = 10% |

Source: Morningstar. Data as of 28 April 2020.
[A] Where an activity contributes to more than one objective, choose only one (Mitigation chosen for activity 2).

In developing the technical screening criteria for aligned activities, the TEG has used the NACE[8] classification system, although other classification systems may also be used. In that case, the TEG recommends that mapping tables from other classification systems to NACE be published on the Platform for Sustainable Finance website in the future.

Lastly, in the case of a company that makes a significant capital expenditure investment, for example, by using the proceeds of an EU green bond to fund development work to make a plant more efficient, it would report that as taxonomy alignment during the life of the bond. The completed work may contribute to the activities of the business meeting the screening criteria, in which case associated turnover would count towards taxonomy compliance going forwards.

**Where, When, and How Investors Will Glean This Company Information**

Companies may report the information as part of their nonfinancial statement, either in their annual report or in a dedicated sustainability report. The disclosures should be self-certified, with no requirement at this stage for external audit, though the TEG recommends that companies do seek external assurance of their taxonomy disclosures. Further, a green bond accreditation scheme is likely to be established in the future that will provide further verification of the use of investments.

At a minimum, companies will be telling investors their degree of alignment with the taxonomy, as shown in Exhibit 3c. To establish that, they will be assessing their activities at an asset and project level, as shown in Exhibit 3a, and this additional context will be helpful to investors if they can see this level of breakdown for all companies.

A range of other voluntary disclosures may also be made, such as activities that are not covered by the taxonomy. In these cases, companies are encouraged to provide an explanation to the effect that the results reflect that their activities are not covered by the taxonomy, distinct from those of their activities that are covered but do not meet any of the criteria.

The wider reporting requirements are covered more fully in a separate paper.

8. Statistical classification of economic activities in the European Community.

## The Taxonomy and Investment Funds

The Taxonomy Regulation imposes obligations on a wide range of financial products, as shown in Exhibit 4, that in turn make them highly dependent on company disclosures.

**Exhibit 4** Taxonomy Regulation and Financial Products

**Investment funds**
- Undertakings for Collective Investment in Transferable Securities (UCITS) management companies
- Alternative Investment Fund Managers (AIFMs)
- Venture capital and private equity funds

**Insurance undertakings making available Insurance-Based Investment Products (IBIPs)**

**Pension funds**
- Institutions for Occupational Retirement Provision (IORPs)
- Manufacturers of pension products
- Pan-European Personal Pension Product (PEPP) providers

**Investment firms or credit institutions providing portfolio management and investment advice.**

Source: Morningstar. Data as of 28 April 2020.

Any of these product types that promote environmental or social characteristics or that have sustainable investment as their objective[9] must make taxonomy-related disclosures in presale documentation and on websites, with effect from end-2021.

Other products may make taxonomy-related disclosures, but if they choose not to, they must carry a standard disclaimer that 'the investment(s) underlying this financial product do not take into account the EU criteria for environmentally sustainable investments.' Whilst this statement makes it sound like a products' holdings are not taxonomy-aligned, it applies equally, if not more so, to products that do not promote ESG as a core goal, even though some of their holdings may be highly taxonomy-aligned.

## A New Lens on Fund Portfolios

A significant amount of narrative-based disclosure can be expected, explaining issues such as how, and to what extent, the EU taxonomy is used to determine the sustainability of the underlying investments, and, if the level of taxonomy alignment is low, why that is–perhaps because the manager is targeting lower-rated but improving companies.

In this paper we focus predominantly on the quantitative metrics that products must measure. The core requirement is to identify what environmental objectives the investments contribute to and the proportion that are taxonomy-aligned, including a breakdown between substantially contributing, enabling, and transition activities.

In identifying the proportion of a fund that can be demonstrated to align with the taxonomy, products may rely on company disclosures without verifying them. They should, however, remain mindful of

9. As defined in articles 8 and 9, respectively, of the Sustainability Disclosures Directive.

general obligations regarding the accuracy of their precontractual and periodic reporting. Alternatively, a product may elect to independently evaluate an investee company's degree of alignment.

The overall proportion of a product that is taxonomy aligned is required, together with its breakdown to the level of each taxonomy objective–that is, climate change mitigation and adaptation in 2022 and across all six objectives from 2023.

It is also recommended to report the proportion that is potentially aligned (where a product has good reason to believe that a portion of its investments would be aligned but could not verify it). In the latter case, the product should explain which criteria could not be verified and why; the due diligence undertaken; any engagement with the company; how any estimates used have been calculated; and how it verified that the DNSH and safeguard criteria are being met by the issuer.

While not recommended, those products that seek to make contributions to objectives that do not have technical screening criteria may disclose the percent of the product they think would align subject to also disclosing how they made the assessment and the due diligence undertaken. This would apply to the four nonclimate objectives during 2022 and also any holdings of companies that do not report taxonomy alignment on an ongoing basis.

The dependency on upstream company reporting quickly becomes apparent. And, in some ways, the calculations for investment product portfolios will be as challenging, if not more so, as those for corporations. Products will have to deal with different degrees of company disclosures, and in many cases no disclosure at all, before having to aggregate the information from across the securities in which they invest.

The volume of information available to investors could multiply quickly, from the proportion of the portfolio that has passed screening criteria; through the breakdown of that proportion across each of the six taxonomy objectives; to the breakdown of each of those into the proportions aligned with enabling or transition activities; and each of these on a turnover and a capital expenditure basis. And then possibly a replication of all that information for the activities that are potentially aligned with the taxonomy.

Further granularity arises with the different treatment of equity and bond investments. Bond-based reporting broadly requires the same as described for equity, plus products will need to disclose the percentage of taxonomy alignment arising from investments in bonds compliant with the EU Green Bond Standard (which will by definition be deemed 100% taxonomy-aligned); bonds partially aligned to taxonomy objectives; and other corporate bonds.

These bond calculations will usually be based on expenditure, except in the case of some corporate bonds, where expenditure would not properly represent the investments made by the company, in which case turnover can be used. In cases where a mix of expenditure and turnover is used, it is recommended they be reported separately.

If we consider an example of a bond issued five years ago, the entire proceeds of which were spent that year on aligned spending, the bond should be marketed as a green bond and the company should ideally disclose the alignment of the bond to the taxonomy. If not, the bond may be considered 'just' a corporate bond that will be evaluated on current expenditure, which may or may not be taxonomy-aligned.

This introduces a subtle difference between green bonds that meet the EU standards and other 'partially green' bonds, such as those issued outside the EU or those from which some of the proceeds are used on green activities. EU green bonds are by definition taxonomy-aligned, while other bonds are recommended, rather than obligated, to disclose data on taxonomy alignment. That recommendation is to report both ex-ante and ex-post on how they are aligned with the taxonomy. Where they do not, financial products that have purchased those bonds will have find other ways to assess how much the use of the proceeds align with the taxonomy.

Although the TEG report is silent on the matter, it is assumed that products which hold a mixed portfolio of equities and bonds will need to combine statistics and, where possible, use the same basis (turnover or expenditure), but care should be taken where a product invests in both bonds and stock of the same company to ensure that double-counting does not occur.

Beyond equity and bond securities, the TEG report is silent on how financial products should treat other securities such as derivatives and short positions.

**Where, When, and How Investors Will Glean This Financial Product Information**

In addition to having pre-contractual documentation updated by the end of 2021, beginning in January 2022, funds will have to undertake periodic reporting, generally in their annual reports, outlining how their strategies have been implemented in practice and a point-in-time calculation of the proportion of their portfolio that is taxonomy-compliant.

That poses an immediate challenge for products because companies' first taxonomy reports will only gradually appear throughout 2022, meaning that many products will be reporting before company data is available.

In Exhibit 5a we illustrate the range of additional sustainability information that, based upon the draft taxonomy regulation and TEG final report, investors might expect to see financial products publish. We show a hypothetical fund, holding a range of security types: an equity holding (the company illustrated in Exhibit 3); a real estate building; an EU green bond; another green bond; and a sovereign bond.

**Exhibit 5a** An Example of a Financial Product Taxonomy Alignment Report: Holdings Breakdown

| | Company 1[A] | | Real Estate[B] | | EU Green Bond[C] | | Green Bond[D] | | Corporate Bond[E] | | Sovereign Bond[F] | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Holding Alignment % | Portfolio Weight % | Holding Alignment % | Portfolio Weight % | Holding Alignment % | Portfolio Weight % | Holding Alignment % | Portfolio Weight % | Holding Alignment % | Portfolio Weight % | Holding Alignment % | Portfolio Weight % |
| **% Weight in Portfolio** | **30** | — | **10** | — | **20** | — | **10** | — | **20** | — | **10** | — |
| **Instrument Objective Level Stats** | | | | | | | | | | | | |
| **Total Climate Mitigation** | **45** | **13.5** | **0** | **0.0** | **0** | **0.0** | **80** | **8.0** | **15** | **3.0** | **15** | **1.5** |
| *Substantial Contribution* | 20 | 6.0 | 0 | 0.0 | 0 | 0.0 | 80 | 8.0 | 0 | 0.0 | 15 | 1.5 |
| *Enabling* | 15 | 4.5 | 0 | 0.0 | 0 | 0.0 | 0 | 0.0 | 10 | 2.0 | 0 | 0.0 |
| *Transition* | 10 | 3.0 | 0 | 0.0 | 0 | 0.0 | 0 | 0.0 | 5 | 1.0 | 0 | 0.0 |
| Potentially Aligned [G] | | | 0 | 0.0 | | | 10 | 1.0 | | | | |
| **Total Climate Adaptation** | **20** | **6.0** | **40** | **4.0** | **100** | **20.0** | **0** | **0.0** | **20** | **4.0** | **20** | **2.0** |
| *Substantial Contribution* | 0 | 0.0 | 0 | 0.0 | 0 | 0.0 | 0 | 0.0 | 0 | 0.0 | 0 | 0.0 |
| *Enabling* | 20 | 6.0 | 40 | 4.0 | 100 | 20.0 | 0 | 0.0 | 20 | 4.0 | 20 | 2.0 |
| *Transition* | 0 | 0.0 | 0 | 0.0 | 0 | 0.0 | 0 | 0.0 | 0 | 0.0 | 0 | 0.0 |
| % Potentially Aligned [G] | | | **5** | **0.5** | | | **0** | **0.0** | | | | |
| **Instrument Level Stats** | | | | | | | | | | | | |
| Taxonomy Eligible | 95 | 28.5 | 100 | 10.0 | 100 | 20.0 | 100 | 10.0 | 90 | 18.0 | 70 | 7.0 |
| **Taxonomy Aligned** | 50 | 15.0 | 40 | 4.0 | 100 | 20.0 | 80 | 8.0 | 25 | 5.0 | 35 | 3.5 |
| *Substantial Contribution* | 20 | 6.0 | 0 | 0.0 | 0 | 0.0 | 80 | 8.0 | 0 | 0.0 | 15 | 1.5 |
| *Enabling* | 20 | 6.0 | 40 | 4.0 | 100 | 20.0 | 0 | 0.0 | 20 | 4.0 | 20 | 2.0 |
| *Transition* | 10 | 3.0 | 0 | 0.0 | 0 | 0.0 | 0 | 0.0 | 5 | 1.0 | 0 | 0.0 |
| Potentially Aligned [G] | | | **5.0** | **0.5** | | | **10** | **1.0** | | | | |

Source: Morningstar. Data as of 28 April 2020.

[A] Company provided data (manufacturer does not need to assess).

[B] Manufacturer needs to assess EU Taxonomy alignment directly.

[C] EU green bonds should report on how proceeds are aligned (manufacturer does not need to assess).

[D] Manufacturer needs to assess by evaluating how proceeds are used (issuers are encouraged to produce a usage report).

[E] Manufacturer should use issuer company information. Company provides alignment.

[F] Further information awaited on how sovereign bonds should be assessed.

[G] Manufacturer must disclose methodology used to assess alignment and why these aspects are only potentially aligned.

While the EU green bond is straightforward, the other green bond may be more problematic. Other green bonds are not obligated to report the use of proceeds, which again might leave the product having to research and estimate the degree of alignment, as it also would for its real estate holding.

In the case of sovereign bonds the TEG acknowledges the need to develop additional rules, which might be based on the alignment of national climate change mitigation targets with net zero by 2050; the sectoral contribution of taxonomy-aligned economic activities to national GDP; or the sectoral contribution of taxonomy-aligned economic activities in the form of tax receipts.

In Exhibit 5b, the fund reports its aggregated alignment at the level of each objective and overall. This is supplemented with the additional aggregations required for the bond holdings, where the guidance is to report as for equities, plus these additional breakdowns.

**Exhibit 5b** An Example of a Financial Product Taxonomy Alignment Report: Portfolio Level

| | Holding Alignment % |
|---|---|
| **Portfolio Summary: By Taxonomy Objective** | |
| **Total Climate Mitigation** | **26.0** |
| *Substantial Contribution* | 15.5 |
| *Enabling* | 6.5 |
| *Transition* | 4.0 |
| Potentially Aligned [A] | **1.0** |
| **Total Climate Adaptation** | **36.0** |
| *Substantial Contribution* | 0.0 |
| *Enabling* | 36.0 |
| *Transition* | 0.0 |
| Potentially Aligned [A] | **0.5** |
| **Portfolio Summary: Taxonomy Alignment** | |
| Covered by Taxonomy | 93.5 |
| Taxonomy Aligned | 55.5 |
| *Substantial Contribution* | 15.5 |
| *Enabling* | 36.0 |
| *Transition* | 4.0 |
| Potentially Aligned [A] | **1.5** |
| **Portfolio Summary: Bond Exposure** | |
| **Bonds** | 60.0 |
| EU Green Bonds (Auto-Aligned) | 20.0 |
| Other Green Bonds | 10.0 |
| Other Green Bonds Aligned | 8.0 |
| Corporate Bonds | 20.0 |
| Corporate Bonds Aligned | 5.0 |
| Sovereign Bonds | 10.0 |
| Sovereign Bonds Aligned [B] | 3.5 |

Source: Morningstar. Data as of 28 April 2020.

[A] Manufacturer must disclose methodology used to assess alignment and why these aspects are only potentially aligned.

[B] Further information awaited on how sovereign bonds should be assessed.

Further guidance is provided to products for how to deal with unavailable data, which may be due to an investee company that is required to report but has not yet done so, or has activities that support objectives 3–6 before the associated technical screening criteria is available, although the latter is not recommended.

Doing so would be onerous for product manufacturers, and different products invested in the same company may generate markedly different results for that company. It's unlikely that all but the keenest products would take steps to identify the activities or use of proceeds conducted by the company or issuer that could be aligned and for which environmental objective(s) and to go on to validate that they do no significant harm to any other objectives as well as meet the minimum safeguards.

To conclude, the recommendations would see disclosures that cover the proportion of a fund, by both turnover and expenditure, that can be demonstrated to align with the taxonomy (whether due to company disclosure or because a product has independently evaluated the company's alignment) and the proportion that is potentially aligned (where there is good reason to believe a portion of a product's investments would be aligned but could not be verified).

## Conclusion

Policymakers have set out their stall to make Europe the first climate-neutral continent by 2050 and appointed the financial-services industry a key participant in achieving it. The intervening years will continue to see much iterative development across all strands of the Sustainable Finance Action Plan—from risk assessment; through investment selection and reporting; to research, data, and ratings services.

The taxonomy can be a valuable tool in reorienting capital flows towards more-sustainable activities by unleashing more clarity around the sustainable activities of companies. In turn, financial product manufacturers will be able to assemble a range of targeted sustainable investment products that will have much tighter reporting and measurement requirements. These can provide investors with a spectrum of choices to match to their own sustainable investment preferences, with more assurance that those products are delivering what they say.

Crucial to its durability and success will be updating the list of activities on a timely and ongoing basis. Innovation in this area is rapid and will likely become more so in the coming years, so it is vital that the positive activities that companies pursue can be identified and benchmarked against the taxonomy for them to remain relevant.

The delegated acts that will follow later in 2020 and 2021 will provide more opportunity to refine the strong base of work and answer some of the remaining open questions and ambiguities highlighted in this paper. Morningstar will continue to feed ideas and comment into the EU rule-making process as it continues.

**About Morningstar Inc.**
Morningstar Manager Research provides independent, fundamental analysis on managed investment strategies. Analyst views are expressed in the form of Morningstar Analyst Ratings, which are derived through research of five key pillars—Process, Performance, Parent, People, and Price. A global research team issues detailed Analyst Reports on strategies that span vehicle, asset class, and geography. Analyst Ratings are subjective in nature and should not be used as the sole basis for investment decisions. An Analyst Rating is an opinion, not a statement of fact, and is not intended to be nor is a guarantee of future performance.

**About Morningstar Manager Research Services**
Morningstar Manager Research Services combines the firm's fund research reports, ratings, software, tools, and proprietary data with access to Morningstar's manager research analysts. It complements internal due-diligence functions for institutions such as banks, wealth managers, insurers, sovereign wealth funds, pensions, endowments, and foundations. Morningstar's manager research analysts are employed by various wholly owned subsidiaries of Morningstar, Inc. including but not limited to Morningstar Research Services LLC (USA), Morningstar UK Ltd, and Morningstar Australasia Pty Ltd.

**For More Information**
Andy Pettit
Director, Policy Research (EMEA)
+44 203 107 0029
andy.pettit@morningstar.com

Tim Walton
Data Director
+44 203 107 0080
tim.walton@morningstar.com

MORNINGSTAR®

1 Oliver's Yard
55-71 City Road
London
EC1Y 1HQ