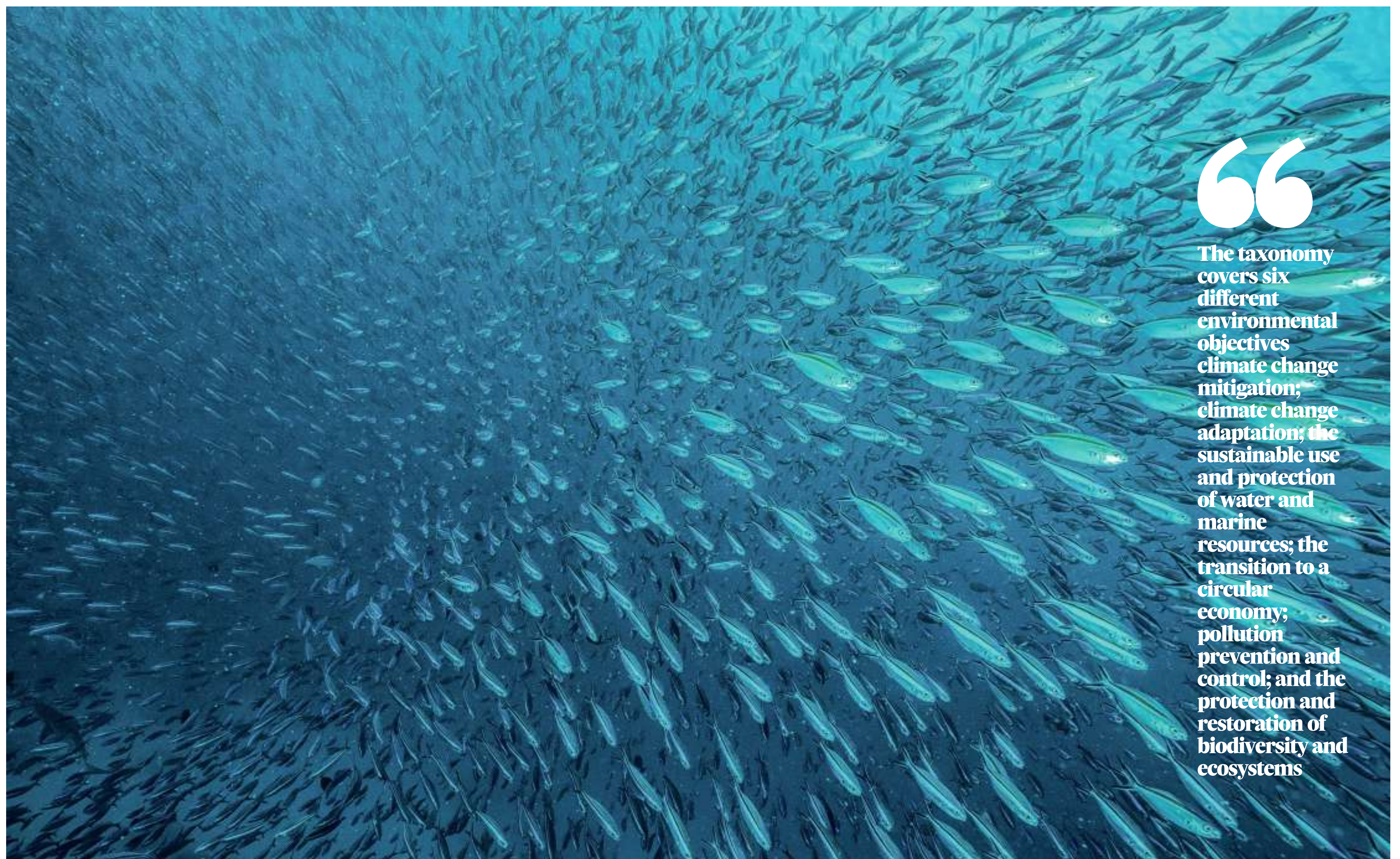
EU moves to create a lingua franca for investment in sustainable activities

Barry McCall

Taxonomy covers six environmental goals, two of which have applied since January 1st



■ Taxonomy covers six different environmental objective including the sustainable use and protection of water and marine resources

The growing popularity of sustainable investment products in recent years has led to what UCD Smurfit School doctoral researcher in sustainable finance Fabiola Schneider calls "a pandemic of greenwashing with mislabelled products misleading investors."

This led to the EU setting out to create its own dictionary of sustainable activities. "The EU taxonomy regulation is a unified classification system for sustainable economic activities," explains Waystone executive director Vanora Madigan. "The aim is to encourage capital flows into those activities. It means that when investors are looking at funds they will be comparing like with like. ESG means so many things to different people, but the taxonomy is creating a common language. It will mean that investors can be better informed in their decision making."

Very importantly, she notes that even funds which do not claim to be sustainable will have to make a negative disclosure under the regulation.

"The aim of the game from an investor perspective is getting the information on what they are investing in," says Simmons & Simmons partner Niamh Ryan. "It's an anti-greenwashing regulation. You can't describe an activity as sustainable without it meeting the criteria set by the regulation. Companies have to prove it. It will encourage managers to have products that include sustainable activities. It applies across the EU, and everyone will know if a product is sustainable or not. Before this, different member states had different definitions."

The taxonomy covers six different environmental objectives: climate change mitigation; climate change adaptation; the sustainable use and protection of water and marine resources; the transition to a circular economy; pollution prevention and control; and the protection and restoration of biodiversity and ecosystems.

The first two of these came into force across the EU on January 1. "It's complicated enough," Ryan notes. "European regulations don't require legislation to come into effect. Funds now need to make disclosures on any investments that fall within the criteria set under those objectives. They also have to declare what doesn't fall within the taxonomy. The remaining objectives will kick in on January 1, 2023."

Detailed screening criteria

And there is more regulation to come in the form of the detailed screening criteria which will be used to determine whether activities meet the terms of taxonomy. "That's meant to come this summer, but it may get kicked down the road," says Madigan.

That potential delay will be welcomed by companies which may be struggling to get to grips with the new requirements. "There is a lot of data out there and getting that data will be a challenge," she adds.

> **The focus is on creating a more sustainable economy by making consideration of the importance of the environment a core element of finance**

"For listed companies it is more obtainable than for many in the private sphere. Firms that are listed have made disclosures already and the information is available to asset managers. In the private world, the data may not be there."

However, efforts are already being made to address that. "Private equity managers tend to reach out to companies and look at the sustainability dimension as part of the due diligence process. And a lot of fund managers have signed up to the ESG Data Convergence Project."

The project's objective is to streamline the private investment industry's approach to collecting and reporting ESG data and to create a critical mass of comparable ESG data from private companies. "They will be able to produce structured reports to share with target companies," says Madigan.

Ryan believes the taxonomy will have a positive impact on investment markets. "You definitely will find managers setting up new funds as a result. We are getting a lot of enquiries from investors in relation to this. They want to invest in funds that qualify as sustainable. We are at the start of the journey in terms of how it takes effect. The taxonomy's aims and objectives will be achieved by increased investor awareness. The focus is on creating a more sustainable economy by making consideration of the importance of the environment a core element of finance."

So far, so good, but the taxonomy became mired in controversy even before it came into effect due to the proposed inclusion of nuclear and gas energy generation as sustainable activities. Schneider explains that the European Commission established the Platform on Sustainable Finance (PSF) as a permanent expert group to assist the development of the EU taxonomy, but it was largely left in the dark when it came to this proposal.

Controversial

"It was a huge task to come up with criteria for all the objectives. That's why only two were implemented on January 1. However, within those two objectives some activities were deemed so controversial that it was going to make decisions on them at a later time. These included nuclear, gas, agriculture and forestry."

But then on New Year's Eve 2021 the Commission published a Complementary Climate Delegated Act which proposed to include certain nuclear and gas energy in the list of economic activities covered by the EU taxonomy.

"The proposal didn't come from the expert group it was the other way around. And the expert group was only given three weeks to consider it. In order to be deemed sustainable an activity has to contribute substantially to the goals and do no significant harm. That's a big problem for nuclear, for example. It can be seen as a source of low carbon energy, but it produces highly toxic waste. And with gas it is hard even for non-experts to understand how climate change mitigation and gas generation can go hand in hand."

The proposal was formally adopted by the Commission on February 2 and it will now go to the Council and the parliament for ratification. They can either accept or reject it but not amend it. Austria and Luxembourg are among the member states which have expressed trenchant opposition and have threatened to launch court actions in relation to it.

The fear now is that the proposal, if allowed to stand, will fatally undermine the taxonomy as a whole. "The Commission's point is that nuclear and gas have been included because they could make a contribution to the transition in the short term," Ryan notes. "And not including them at all could be problematic. It's hard to say when we are at such an early stage what the impact will be. I would be very disappointed if all the good work and effort done to date is undermined by this proposal, but we don't know if that will happen."

Madigan understands why some people are upset by the proposal but believes that perfect could be the enemy of good in this case. "Under the EU Regulation on sustainability-related disclosures in the financial services sector (the SFDR) you can have gas and nuclear investments and still be green. But I can see why that wouldn't work for some investors. We've got to start somewhere though. We are starting from a place where there is no common language at all."

Irish Pensions Awards 2021 WINNER Investment Manager of the Year
Irish Pensions Awards 2021 WINNER Passive Manager

Quiet enough to listen, loud enough to be heard

We use our influence to act on the issues that matter most to our clients.

lgim.com

For investment professionals only
Capital at risk

LGIM

Issued by Legal & General Investment Management Limited. Registered in England and Wales No. 02091894. Registered Office: One Coleman Street, London, EC2R 5AA. Authorised and regulated in the UK by the Financial Conduct Authority.

LGIM Managers (Europe) Limited, authorised by the Central Bank of Ireland as a UCITS management company (pursuant to European Communities (UCITS) Regulations, 2011 (S.I. No. 352 of 2011), as amended) and as an alternative investment fund manager with "top up" permissions which enable the firm to carry out certain additional MiFID investment services (pursuant to the EU (AIFM) Regulations 2013 (S.I. No. 257 of 2013), as amended). Registered in Ireland with the Companies Registration Office (No. 609677). Registered Office: 70 Sir John Rogerson's Quay, Dublin, 2, Ireland. Regulated by the Central Bank of Ireland (No. C173733).

'Tough but fair' Central Bank regulation keeps State a leader in funds industry

Sandra O'Connell

Increase in UK and US managers establishing funds in Ireland due to Brexit

The post-Brexit period has demonstrated that Ireland's funds industry is proactive and flexible. It also works very well with the Central Bank, its regulator. In an industry where good regulation offers a clear point of competitive advantage, that matters.

"The Central Bank of Ireland provides a tough but fair regulatory environment, which is an attraction for international asset managers," explains Fionán Breathnach, who leads the Irish office of UK law firm Simmons & Simmons.

"They know that if they are operating in a robust regulatory framework, that is attractive to their investors."

Post-Brexit not only is the industry seeing a lot of UK managers establishing funds in Ireland, but US asset managers are using Ireland as a springboard into Europe, where previously they would have used the United Kingdom.

"This is because of the common language here, the common legal system of common law and an approach to doing business that is aligned with the UK and US," says Breathnach.

Ireland is the largest domicile for exchange traded funds (ETF) in Europe, home to more than 60 per cent of the total European ETF market. It is also Europe's leading centre for alternative funds and the largest hedge fund domicile in Europe. Indeed, Ireland was the first regulated jurisdiction to provide a regulatory framework specifically for the alternative investment fund industry.

■ Cryptocurrency is an area of particular interest for Ireland. PHOTOGRAPH: ISTOCK

New investment limited partnership legislation, which came into law just more than a year ago, provides a regulated fund offering suited to private equity too, a growth sector.

Continued investment

It was one of the priorities of the Government's Ireland for Finance strategy, designed to build on Ireland's existing position as a global centre of excellence for funds and to enable competitiveness in a dynamic segment of the industry.

Continued investment in innovation is important, says Breathnach, including fintech, a sector that depends on a mix of technology, regulation and people. "We need to continue to invest in all three," he says.

Cryptocurrency is an area of particular interest for Ireland. "We have the ideal product, in QIAIFs (qualifying investor alternative investment funds) for that investment class," says Breathnach.

"In recent years one of the things the industry has been grappling with in relation to digital assets is around custody of them. The depositaries here have done a good job to get on top of that, so the path is there to look at crypto funds. There is an inevitability around them, and as an industry it is something we should be looking hard at."

> **In recent years one of the things the industry has been grappling with in relation to digital assets is around custody of them**

While the industry's regulation is largely European, the manner in which we implement matters. "It's really important that we don't set ourselves apart," says Donnacha O'Connor, managing partner and head of the asset management and investment funds at Dillon Eustace.

The funds industry depends on highly skilled personnel and has seen a number of people relocate here from the UK post-Brexit. For that to work Ireland has to compete on a work-life basis too.

"We need well-qualified staff to work in this industry and we are competing for them with other European jurisdictions in an industry that is very mobile. Wage inflation and the cost of living are all factors. People looking to come here look at the same things we look at. The price of homes, the availability of schools and tax all play a big part," says O'Connor.

Big rival

Luxembourg is Ireland's big rival. "What you have in Ireland and Luxembourg is a regulated product that can be sold throughout the EU. There is intense competition between the two because if you are coming into the EU, and want to launch an EU product, it's one of those two countries you'll be looking at," says Kevin Murphy co-head of Arthur Cox's Asset Management and Investment Funds Group.

"We have very responsive regulation. We're English speaking and a lot of these managers are based in the US or UK. Our workforce is also very responsive to US work hours. The expertise we have built up over 30 years in international financial services has a very high reputation," says Murphy.

"It is critical that we have a product range that allows us to be competitive with the likes of Luxembourg and that we do not become complacent in being a leading financial services sector in the EU post-Brexit."