

Sustainable finance in the EU: implementing the commitment to 'Do No Significant Harm'

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In view of the growing importance of sustainable finance to complement the legislative agenda of the European Green Deal, this Briefing introduces the Taxonomy Regulation and the underlying principle of Do No Significant Harm (DNSH). The DNSH principle is at the heart of a classification system of environmentally sustainable economic activities, which is applicable in several pieces of legislation in the area of sustainable finance. The Briefing discusses the challenges of implementing the DNSH principle, highlighting the growth in substantive and regulatory complexity, and the importance of capacity-building for both private and public actors.

Introduction

Sustainable finance is a key element of the European Green Deal, complementing policy initiatives on climate change, environmental protection, circular economy and pollution prevention.

The notion has gained traction with the adoption of the [Action Plan: Financing Sustainable Growth](#) in 2018 and the [Strategy for Financing the Transition to a Sustainable Economy](#) in 2021. The aim is to mainstream sustainability in the internal market and to channel financial investment into sustainable economic activities.

At the heart of this framework is the 2020 [Taxonomy Regulation](#) which establishes a classification of sustainable economic activities. Based on the Taxonomy, the Sustainable Finance Disclosure Regulation and the proposed Corporate Sustainability Reporting Directive require enterprises to disclose sustainability-related information

about their business operations. Additional tools for mainstreaming sustainability while preventing 'greenwashing' are under development, for example European green bonds.

A key principle is Do No Significant Harm (DNSH). The DNSH principle informs the classification of sustainable economic activities, disclosure requirements for businesses, the activities of the European Investment Bank Group as well as the green transition in cohesion policy and the Recovery and Resilience Facility (see the companion EIPA Briefing by Marco Lopriore and Maureen Cossalter).

This Briefing discusses the implementation of the DNSH principle, focussing on the controversies over the technical specifications. Against the backdrop of possible extensions of the Taxonomy to cover sustainable activities in the entire economy, these specifications have economic and political repercussions, which might jeopardise the effectiveness of the sustainable finance framework.

Classifying environmentally sustainable economic activities: the Taxonomy Regulation

The Taxonomy does not prescribe sectors or businesses in which financial markets are obliged to invest, but classifies environmentally sustainable economic activities. As such, it is a transparency tool intended to channel capital flows towards sustainable investment. Economic activities will qualify as environmentally sustainable if they satisfy three conditions.

First, activities have to make a '*substantial contribution*' to the six environmental objectives in Article 9:

1. climate change mitigation;
2. adaptation to climate change and prevention of natural hazards;
3. water resource management and protection of marine resources;
4. the transition to a circular economy and the management of technological risks;
5. the fight against air, water and soil pollution;

6. the protection of biodiversity and natural, agricultural and forestry areas.

Second, taking into account the life cycle of a product or service, activities must **not harm** any of the six objectives, i.e. Do No Significant Harm.

Third, economic activities must be carried out in compliance with minimum **social safeguards** aligned with international guidelines and conventions.

To further specify the criteria that economic activities have to fulfil, the Taxonomy requires the establishment of **technical screening criteria** for each of these objectives. The regulation confers upon the Commission the power to establish these criteria through delegated acts.

Implementing the Taxonomy: delegated acts

Before adopting delegated acts, the Commission must consult experts from all Member States as well as stakeholders and other experts. In this case, there are two expert groups: the Member States Expert Group on Sustainable Finance (henceforth Expert Group) and the Platform on Sustainable Finance (henceforth Platform). The Expert Group was created in 2018 following the adoption of the Action Plan and given formal status in the Taxonomy Regulation while the Platform was created through the regulation. The main difference is the composition: the Expert Group is composed of EU Member State representatives, while the Platform has broader representation.

Once the Commission has adopted delegated acts, the Commission notifies the European Parliament and the Council. The delegated act can only be published in the Official Journal and enter into force if neither the EP nor the Council 'objects' before the deadline.

Delegated acts: technical specifications and controversies

The first delegated act, the so-called **Climate Delegated Act** on technical screening criteria for economic activities related to climate change mitigation and adaptation, entered into force on 1 January 2022.

The second delegated act, also entering into force on 1 January 2022, specified the information to be disclosed by non-financial enterprises in relation to economic activities that qualify as environmentally sustainable.

In March 2022, the Commission adopted a third delegated act, the so-called **Complementary Climate Delegated Act** (henceforth Complementary Act). This establishes criteria for economic activities in the energy sector which were not included in the Climate Delegated Act, notably gas and nuclear energy. The Complementary Act thus aligns these criteria with the Taxonomy, meaning that gas and nuclear, under specific conditions, can be considered as environmentally sustainable, contributing to climate change mitigation and to adaptation as a 'transitional' economic activity.

In both Expert Group and Platform, the delegated act was met with criticism, and the latter in particular had serious concerns with regard to the inclusion of gas and nuclear energy. The Platform argued that the Complementary Act distinguishes between general and additional criteria relating to substantial contribution and DNSH. Since this distinction was not made in the Climate Delegated Act, the implementation of the Taxonomy was seen as incoherent.

Moreover, the Platform stated that criteria in the Complementary Act are not consistent with the Taxonomy Regulation and that gas and nuclear energy can therefore not be considered sustainable economic activities. Both Expert Group and Platform took issue with the specification of the technical criteria, such as the role of nuclear energy as transitional activity, the expected time frame of operation in nuclear energy, the coverage of lifecycle activities and, more generally, the impact of technological neutrality and the impact of gas and nuclear energy systems on other environmental objectives, thus violating the DNSH principle.

The delegated act also met opposition from some Member States and the EP. In addition to the substantive criticism expressed in the Expert Group and Platform, the ECON and ENVI committees, which are jointly responsible for the file, criticised the fact that no public consultation and no impact assessment was conducted prior to adopting the act. In June 2022, the two committees adopted a draft

motion proposing that the EP should object to the delegated act, to be voted on in plenary in early July.

Political implications and potential economic consequences

EU-level implementation

In the formulation stage of the Taxonomy Regulation, the then existing Technical Expert Group on Sustainable Finance did not recommend including economic activities in the nuclear energy sector, because no conclusive advice could be given on the basis of available scientific evidence. After the adoption of the regulation, the Commission mandated the Joint Research Centre (JRC) to assess DNSH-related aspects of nuclear energy.

The [JRC report](#) concluded that nuclear energy can make a substantial contribution to climate change mitigation while also doing no significant harm to the other environmental objectives. In reviewing the report, other EU bodies were generally supportive but also critical of the conclusion.

Throughout the policy-making process, experts have deliberated extensively on the issue of nuclear energy from the perspective of DNSH, but no consensus was found. The Commission was criticised by stakeholders and MEPs for having based the inclusion of gas and nuclear energy on 'political criteria'. Environmental NGOs are concerned that the Complementary Act might incentivise the channelling of investment into gas and nuclear energy, thus undermining the environmental objectives of the Taxonomy, whereas the reliance on gas has become a geopolitical risk. These concerns echo criticism by financial actors. For instance, the Principles of Responsible Investment (PRI), an initiative by over 1,000 institutional investors supported by the UN, has stated that, should the Complementary Act be adopted, the Taxonomy 'can no longer be considered the gold standard for a sustainability performance benchmark'. NGOs and financial actors share the view that by including gas and nuclear, the Complementary Act risks undermining the credibility of the Taxonomy. This risk is exacerbated by possible legal challenges before the Court.

However, it is difficult to see how, in the absence of scientific consensus, such a decision can be anything other than political, regardless of whether this decision is made by the Commission through a delegated act or, possibly, through a legislative revision of the Taxonomy by the EP and Council.

National-level implementation

The Taxonomy Regulation is based on the internal market provisions of the treaty. This reflects the rationale that international commitments for climate action and sustainable growth will encourage Member States to establish their own classification and labelling schemes to channel investment. This could lead to fragmentation, disincentivising cross-border investment and, thus, undermine the integration of capital markets in the EU. Hence, the Taxonomy establishes a common framework for Member States to apply when introducing national requirements for businesses in terms of reporting and classifying financial products.

Given the complexity of the subject and the high level of technical specification for implementation, national authorities need to be equipped with sufficient administrative and legal capacities to apply the Taxonomy and to monitor application by businesses. This is beginning to materialise. As part of the Technical Support Instrument (TSI) which was established in February 2021 to support Member States in public sector reform, two Member States (Finland and Czechia) have submitted projects related to the development of methodologies and guidelines to implement the DNSH at national level. Moreover, in 2023 the TSI will include a multi-country flagship project titled 'Integration of environmental dimensions in public finances – Implementing the Do No Significant Harm (DNSH) principle in public funding programmes'.

These projects aim to streamline the DNSH principle across different sources of EU and national funding and to increase Member States' capacities to implement the principle. TSI projects apply several methods such as case studies, peer learning and exchange of best practices, as well as review of existing national legislation and guidance.

Private implementation

In addition to EU- and national-level implementation, the Taxonomy is to be put into effect by private financial and non-financial enterprises. This includes requirements related to provisions of financial products, the disclosure of information about sustainable investments at the product and portfolio level and, for non-financial enterprises, reporting about sustainable economic activities. Like national authorities, private actors are concerned with capacity-building to allow for effective adaptation of business practices in line with the Taxonomy. Initiatives such as PRI, therefore, have stepped up their efforts to build capacities. Yet taxonomy practitioners have explicitly called on policy makers to provide clarity about pending legislation in the sustainable finance framework, sufficient guidance on how to apply the Taxonomy, and fora for interaction between regulators and businesses.

Conclusion

The implementation of the Taxonomy Regulation shows how technical and regulatory complexity increases with every delegated act adopted. Part of the explanation is that in order to accommodate diverging political views, technical specifications may have to be adjusted, and this, as is the case with the Climate Delegated Act and the Complementary Act, may lead to incoherent specification of legal provisions. This incoherence is a challenge for national-level and private implementation and risks undermining the credibility of the Taxonomy. It can be expected that these challenges will further increase for two reasons.

First, the Taxonomy does not classify a wide variety of economic activities and would have to be extended to fully realise its potential for mainstreaming sustainability in the entire economy. According to the Platform, this would require a more fine-tuned classification of economic activities. Yet, at this point there seems to be limited appetite among policy makers to amend the foundations of the Taxonomy Regulation.

Second, there is a mushrooming of sustainable finance initiatives across the globe, which develop parallel to the EU framework. Given the variation in approaches, including

mandatory frameworks as well as voluntary and market-driven instruments, there is a risk of regulatory fragmentation vis-à-vis global financial markets. To address this risk, the EU- and China-led Common Ground Taxonomy, launched by the International Platform on Sustainable Finance, is geared towards harmonising taxonomies at the global level.

Implementation of the Taxonomy and the specification of the DNSH principle will therefore remain controversial, and substantive and regulatory complexity is likely to increase. Building capacities to manage these challenges should be a priority for public and private actors if this important dimension of ensuring more sustainable growth is going to be successful.