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RPM Ep 11 Transcript

MV: You're listening to RPM, the podcast that explores the world of private markets. I'm your host, Michael Venne. This is the first special episode in which Graziella and I are passing the baton, so to speak, to our colleague Suzanne Tavill, StepStone's head of responsible investment. In part one of our special series, Linda Romanovska, an expert in sustainable finance and one of the architects of the EU's climate change program, joins Suzanne to discuss the intricacies and finer points of that program. They cover a lot of ground in a short amount of time, so without further ado, our conversation with Linda Romanovska.

ST: Thank you, Michael, and welcome, Linda. I am so excited to have Linda with us today because Linda brings with her both historical knowledge, as well as very current present-day knowledge on what is happening with Europe and their massive agenda around climate change. You know, Linda was one of the authors of the original strategy for the European Union on adaptation to climate change. Today sits, as Michael had mentioned, in her personal capacity, as one of five independent experts to the platform on sustainable finance, and that really gives her such a brilliant overview of all what is going on there out from a policy perspective through to some very, very ambitious initiatives such as the European taxonomy. So today we're going to cover quite a bit of ground. And let me get started by asking Linda, how come did Europe manage to become a leader around climate action?

LR: Thanks for having me. It's really a pleasure for me today to be here and speak to you. And on that question around the leadership role of European Union and Europe on climate change, I think there's a long, long history behind that. Europe has seen itself as a leader on climate change since several decades already, but I think what's more interesting right now is really the recent acceleration in this area and to really understand the origins and how that's happened, I think the whole story is a really interesting illustration of how a set of different events and conditions suddenly propelled Europe forward in this area. So, search for the origins we could look back to year 2019 and the run up to that year, because that was an important year for the European Union. It was the year of the European Parliament elections and in the run up to these elections, there was a real green wave that had started to sweep across Europe.

So because of this green wave, there was increased awareness and concern among voters around climate change and environmental issues. And largely, that was driven because there was the IPCC report that had come out the IPCC 1.5-degree report. There were talks about Green New Deal in the US. Greta Thunberg's Fridays for Future movement was taking off, and it was gathering tens of thousands of people in the streets of European cities. And so, in their pre-election campaigns, the green parties were really riding this wave and listening to these concerns and putting forward programmes that really address these issues and concerns. And they were increasingly gaining popularity, especially in the large western European countries and the Nordics. And so, the other parties were in a way pressured to also have positions and look into these issues on climate change and environment. Also, there was this polarization rising at that time of pro and anti-European sentiment, and a combination of all these factors led to the fact that the European Parliament elections in 2019 attracted market increase of voter turnout and especially in the younger age groups. And these are exactly those age groups which are in particular concerned with climate change issues because it really directly affects their lives and their futures.

And after the election, the exit polls showed that climate change had become the second most important issue and even motivation to participate in the polls. It came second after economic issues. So as a result of the elections, the Greens, the green parties had significantly increased their representation, and this increase was at the cost of previously dominating center, center-right, center-left parties. And at the same time, we had this far right, largely populist parties, gaining popularity and there were more in the anti-EU view corner. So, in order to have a strong pro-EU coalition, the centrists had to negotiate with the Greens now to achieve a majority, and that gave the green parties a very powerful negotiating power. And, of course, the Greens, because the climate change was one of their election promises, they put that forward as their non-negotiable. So, at the end there was an overall agreement that climate action and environmental action will be very important and will take center stage in the future of the European Union. And within just a few months, the European Green Deal was drafted. It was unveiled in December 2019, and at that time, the president of the European Commission was calling it the Europe's *man on the Moon* moment, because the plan would make Europe the first climate neutral continent.

By January, the European Parliament overwhelmingly voted to support the deal as well. Even with requests for higher ambition, for example, the parliament requested that there are higher emissions reduction targets by 2030, that there should be also an interim target for 2040. It also called for a WTO compliant carbon border adjustment mechanism, which effectively would put a carbon tax on imports from countries with insufficient climate ambition or no carbon price. That's all the all these things that really led to the creation of the European Green Deal and adoption of it and European Green Deal truly is a highly ambitious, overarching strategy moving Europe towards a more sustainable future.

ST: Wow. It is amazing when you think about how much has happened in such a short period of time, and it's interesting because everyone always considers how something as bureaucratic as the European Union construct, you know, would expect that it would never be able to move with such speed. And yet it has. So you flagged the issue of the Sustainable Finance Strategy and within that, we know, as you said, it's critical to enable the Green Deal. But in itself there it has a number of important pillars and each of these pillars are quite vast in and of themselves, for example, like the European taxonomy. I think it's often difficult for laypeople, you know, to understand how all these pillars interconnect and work together holistically. So if you can present sort of that sort of the grand plan of how this all comes together, I think that would be pretty helpful.

LR: There are three key pillars in this framework. As you already said, one of the really most important elements is the EU taxonomy, because EU taxonomy is a common classification of which economic activities legitimately can be considered sustainable, meaning which of them truly substantially contribute to predefined goals, which are currently climate change goals, environmental goals and in the future, also social objectives. This taxonomy is science based. It follows the Paris Agreement target, and it is developed in a large collaboration with different stakeholders that are also members of the platform where also working. And this really is the rulebook. This is the background and the ground level of building this common understanding of what is sustainable so that then we can identify and find ways of how we can channel capital in these sustainable activities.

The taxonomy regulation itself was adopted in year 2020, and it is now rolling in implementation. We have the first delegated act, which is about to be fully adopted. That first delegated act lays out the taxonomy for two climate objectives: mitigation of climate change and adaptation of climate change and in the near future we are also looking of starting to have discussions around the second delegated act, which will be targeted towards environmental objectives.

The second important pillar, which is also something that is very, very important, is the disclosure regime because we need to in one way or another, mandate disclosures of that then link to this taxonomy. The disclosure regime targets both financial and non-financial corporates, setting various requirements to provide investors with the information necessary to make sustainable investment choices. So the non-financial corporates will be obliged to report on their alignment with the taxonomy, meaning they will look into this classification of economic activities and will identify whether they are carrying out any of these activities and whether they do fulfil the criteria that would make this activity sustainable. The financial corporates, on the other hand, will look in their investment portfolios and will assess and report transparently what share of those investments are in these companies that align with the taxonomy definitions. The disclosure regime, just like the taxonomy, is currently in development. Some elements of it are already in force, some are in development. So this is a rapidly changing area, and market participants really should be keeping their eyes open to understand what other requirements are coming their way.

The third pillar is different tools that we are or the European Commission is planning to develop or is already developing that help companies and market participants, financial intermediaries to develop sustainable investment solutions and maybe also identify them as sustainable. For example, the EU climate benchmark regulation. There's also standard for European green bonds, which is currently being proposed and we are waiting for its adoption. There are also future plans for EU Green Label for financial products. So the taxonomy, together with the disclosures framework and the tools, the supporting tools, those are the three pillars of the sustainable finance framework.

ST: Thanks, Linda. That was a lot covered very, very efficiently. And certainly, I take your point about the disclosure regime, certainly as funds, fund managers work through this. You know, there is the challenge, obviously, at this point in time where they need the data being produced by the underlying companies, as you said, those non-financial companies, to be able to make some of the determinations themselves. So it is quite a challenging time, but you know, as there's some sort of disconnects in terms of everything lining up. But I take the point that it ultimately, as this gets fully implemented, hopefully that gets increasingly streamlined. So let's turn to talk about the taxonomy. So the taxonomy, as you said, really is the giant definition of what is sustainable and what we as investors should be allocating capital towards if we want to be making sustainable investments. But it is interesting to me that the taxonomy, you know, takes such a broad definition, I suppose an understanding of what is sustainability.

LR: European Green Deal has a variety of targets and we need to address all of them in this taxonomy if we want to finance their implementation and achievement. And that's why the targets are objectives that are included in the taxonomy are closely aligned with the objectives of the EU Green Deal. So, as I already mentioned for climate change, we are looking at mitigation and adaptation of climate change. For the environment we are looking at four different objectives: transition to a circular economy, pollution prevention and control, sustainable use and protection of water and marine resources, and the protection and restoration of biodiversity and ecosystems. In terms of the social objectives, as I said before, the social taxonomy is still in early stages of development. It's a more complex field. Also, we do not have as clear cut objectives in the social policy area in Europe, and that's why more work is necessary on this. But what we're looking at is issues around respect for human rights impacts, for example, the impact that companies are having on both their employees and workers and consumers on communities and how they manage this impact.

ST: If something meets one of these objectives and activity meets an objective say it in climate change adaptation, mitigation. Just very briefly, the other hurdles that need to get considered before one can, in a sense, put a real tick next to that name, in terms of saying yes, it is aligned to the taxonomy.

LR: Yes. So to determine whether an activity is sustainable, we use the term substantial contribution. So the activity, as you said, needs to substantially contribute to at least one of these currently six objectives to climate and for environmental objectives. And this substantial contribution is determined by a set of criteria. So all of these criteria for substantial contribution need to be fulfilled and if they are fulfilled, the economic activity is considered aligned. At the same time, we also are looking at whether the activity does not significant harm to any of the other five objectives. So the other key concept here is *do no significant harm* concept. It's not enough to substantially contribute, let's say, to waste reduction, but then have high greenhouse gas emissions under the mitigation objective. So that to avoid this situation, there's another set of criteria at the *do no significant harm* level and those also need to be fulfilled for all the other objectives. And then at the same time, because there also is no detailed social taxonomy in place, we have a concept called minimum safeguards and these are minimum social safeguards, for example, the UN Guiding Principles, or OSCE guidelines that need to be fulfilled in addition to the substantial contribution and *do not significant harm*.

ST: In July this year, we know that the European Union rolled out their updated sustainable finance strategy. Obviously, that had the Fit for 55, you know, with 55% reduction in greenhouse gas objective by 2030. So this continual lift in ambition was evident, and a lot of those issues obviously got a lot of headlines. But there were some other parts of the strategy that were quite interesting. And maybe we can just briefly touch on those so you can give sort of a perspective of why they are important or why they were raised. So the first one was this ambition to create a centralised data repository. Just talk to us what's going on with with that idea.

LR: This idea around including the sustainability data that are being reported, will be reported by the companies and financial institutions under the disclosure regime requirements to include that into the European single access point. That would create a EU wide mechanism offering easily accessible, comparable and digitally usable databases on the data that have been reported, and this is really in response to the concerns in the market. This is one of the biggest concerns that we see in the private sector currently, especially among the financial market participants around the data and data access as they are trying to prepare for their reporting and fulfilment of their requirements. So, this is really to make it more accessible in one access point, but also in a harmonised format. And this also explains why a lot of the reporting requirements come in standard templates because we need those standard formats reporting being fed into one database for it to be aligned accessible.

ST: Yeah, sure. Certainly, it would be amazing the idea of standard reporting templates, standardized data. Things get a whole lot easier if we can realise that ambition. You know, there are other point that was referenced. Obviously, it was the idea of global cooperation and European Union taking leadership in a variety of forums. I think people are quite interested to understand, is there ever going to be sort of a global unified taxonomy? Sort of what is what is the way forward on that?

LR: There certainly is a move towards alignment internationally. While we have the tendency currently of various jurisdictions, more than a dozen currently that are working on their own frameworks and economies, or sometimes they are not called taxonomies, but they are similar systems of classification. At the same time, each of the different countries are looking at each other, and a lot of them are looking at what Europe is doing and trying to align in one way or another with the European framework. Sometimes the alignment is very high, so sometimes the approach taken would be very close to the European approach. Sometimes the alignment is rather in the principles or in the methodologies, if not in the content itself, in terms of criteria and range of activities. What European Union with the strategy is aiming to do is, first of all, increase the international ambition. So try and raise the ambition level in the different initiatives that are now arising and being put in place internationally, such as the Financial Stability Board or the G20 Sustainable Finance Working Group. At the same time, European Union also aims to drive towards more consensus and increase standardization. For example, they endorse the IFRS Foundation's work to develop more ambitious standards and principles, also for disclosure and also building on some of the existing voluntary frameworks recommendations, for example, the Task Force on Climate Related Financial Disclosures or other international initiatives. And at the same time, EU is also convening and leading the work in the international platform on sustainable finance, which brings together 16 different jurisdictions, and, as part of that work, one of the immediate tasks currently is the development of common ground taxonomy, where EU is leading together with China. We are expecting the first report on the common ground taxonomy to come out in November, hopefully in time for COP26. And what the common ground taxonomy does currently is look at the agreement points, looking at the different taxonomies and classifications and identifying where there is agreement.

ST: There was discussion in the strategy around mobilising retail, capital and public pension fund capital towards sustainable investing. I mean, we understand obviously the demand for capital is enormous to drive, you know, a comprehensive push to a sustainable economy. But why highlight these two groups in particular?

LR: I think these two groups are highlighted very much because they are addressed to a lesser extent currently by the current framework, and both of them are, however, important. Loans represent a significant share of capital flows in the EU, especially it is the main funding source for SMEs and SMEs represent 99% of all businesses in Europe, and they account for around half of the GDP of the European Union. At the same time, these SMEs are some of the most sustainable businesses. It's estimated that around one quarter of SMEs in EU offer green products or services. But because of their size and characteristics, they are currently excluded from the framework. So, the question is how do we reconnect the sustainable finance which could, in this case, come through loans with these green SMEs that are driving some of the sustainability agenda with their work? And how do we recognise and reward these SMEs? And therefore, this action actually comes in the strategy comes under how do we increase inclusiveness of the sustainable finance framework in this case by including SMEs and enabling access to green finance for them? And yes, and also the other motivation here is to better integrate this important financial flow in the framework.

And as regards the pension funds, in a lot of cases, the sum of the current requirements do not automatically apply to many of the pension funds in the EU, as they would not fulfil the criteria to be in scope. They are also very often not direct investors. They are often left in that group that can take voluntary approach. And there is a mixed reaction to that. Some funds have taken on the obligations to report voluntarily and to be included, and others have not or are taking the wait and see approach currently. Altogether, there are under 25000 pension funds in the EU, and they're collecting pension schemes for 75 million Europeans. So the scale is really large here. And therefore, what the commission intends to do in this regard is to see if they could clarify the fiduciary duties of pension funds and expand the concept of long-term best interests of members and beneficiaries to expand it in a way that it would include an obligation to consider sustainability impact in investment decision making processes for these pension schemes, and this will be done already in the near future. The plan is for a year 2022.

ST: Very interesting and very relevant, I'm sure, for many, many of our listeners. So that brings us really to the end of our discussion today, and we have covered a lot of ground. And I really wanted to thank you, Linda, for your time for sharing of your knowledge. I think as anyone listening would agree, the area is complex. It is fast moving, but it is also important as we look to address some of these effectively existential crises that face our society. And it is really, I think we probably really fortunate that there is this type of leadership being taken out of the European Union and hopefully we see them being well supported by other jurisdictions going forward. So thank you again and a pleasure talking to you.

LR: Thanks to you. It has been an. Absolute pleasure to talk to you.

MV: That does it for this episode of RPM. Special thanks to Linda for joining us. Our climate change special continues with the next episode in which Suzanne is joined by Carl Prins, the CEO of Pathzero and an expert of net zero and carbon footprinting. If you enjoyed this episode, please visit our show page at www.stepstonegroup.com. You can also find RPM on Apple, Spotify, Stitcher and other podcast platforms.