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Sustainable Finance Taxonomy of the EU

In times of acknowledging industrial impact on the climate change, setting sustainable development goals (SDGs) and implementing sustainable ways of living have become the most important factors for improving global environment and supporting social and economic welfare. Today we will talk about what steps the European Union is taking to move forward in creating «green» economies and how effective they might be by analyzing the new Taxonomy Regulation of the EU.

According to the Final report of the Technical Expert Group on Sustainable Finance (the TEG), the EU Taxonomy Regulation (which has entered into force on 12th of July 2020) is a tool to help investors, companies and project promoters navigate the transition to a low-carbon, resilient and resource-efficient economy. To put it more simply, it is a regulatory classification system which can help financial market subjects to define which of their economic activities are environmentally sustainable. The EU claims that this Taxonomy is one of the most significant developments in sustainable finance for their countries. But they also note that not every investment and financing decision is expected to contribute additional environmental benefits.

To start, we will review the main elements of the regulation. First, the Taxonomy has set six environmental objectives for the EU and its economic participants to accomplish: climate change mitigation; climate change adaptation; sustainability and protection of water and marine resources; transition to a circular economy; pollution prevention and control; protection and restoration of biodiversity and ecosystems.

Second, in terms of the Taxonomy Regulation, sustainability of financial market subjects' activities is defined by next criteria:

1) make a substantive contribution to at least one of the six environmental objectives as defined in the Regulation;

2) do no significant harm to any of the other five environmental objectives as defined in the proposed Regulation;

3) comply with minimum governance safeguards (e.g., OECD Guidelines on Multinational Enterprises and the UN Guiding Principles on Business and Human Rights).

Technical screening criteria for activities that make a substantial contribution to water, a circular economy, pollution prevention and control, and protection of ecosystems will be issued by the end of 2021, which is important for further evaluation of participants' sustainability levels.

Altogether, all of the requirements, measures and rules for investors and other financial market participants' activities and disclosures on their sustainability are based on those elements.

Now we will focus on who exactly are the Taxonomy users and the obligations created under the Taxonomy Regulation. There are three groups of the regulation users: financial market participants offering financial products in the EU, including occupational pension providers; large companies who are already required to provide a non-financial statement under the Non-Financial Reporting Directive; the EU and Member States, when setting public measures, standards or labels for green financial products or green (corporate) bonds.

The Taxonomy mandates subjects to report on and disclose the extent to which their business activities are aligned with regulations' definition of sustainable. Even though the TEG recognizes that there are timeline challenges to implementation, financial market participants will be required to complete their first set of disclosures, covering the climate change mitigation and climate change adaptation objectives, in their periodic reports and on websites by 31st of December 2021. Large public interest companies are requested to do the same sustainability reports during the course of 2022.

After reviewing the main parts of the Taxonomy Regulation, let's take talk about possible consequences. Firstly, the new Taxonomy of the EU might influence other countries to develop such regulatory framework, which can spread the awareness about the global issues (especially climate change) and urge to solve them. Secondly, if the disclosing financial market participant is already operating sustainably within the Taxonomy criteria, it will attract more positive publicity and could also make this subject more investible. Thirdly, economic subjects can use the Taxonomy Regulation to avoid misleading investors about the environmental benefits of a product or company (in other words, a marketing strategy named as «green washing»).

To conclude, the Taxonomy Regulation has only come into effect, so we have yet to see how will it work for attaining sustainability in the EU. It might be a great step further in creating sustainable economy, if governed in the right way. However, SDGs can't be accomplished by just elaborating «eco-friendly» frameworks for financial sector, but also by solving social issues and implementing stricter environmental regulations, which can guarantee long-term socio-economic welfare.