Recognition of Issues Surrounding Trends in Sustainable Finance

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Working Group on Global Environment Strategy,
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There has recently been an increase in international discussion regarding sustainable finance, particularly in the EU. While sustainable finance aims to expand private investments towards combatting climate change in particular, there is a risk that arbitrary policy guidance on the matter may have significant impacts on a wider range of policy arenas that extend beyond the field of climate change.

Furthermore, as financial and business activities globalize, the impacts of measures taken by specific countries and regions are not self-contained and may spread globally. Thus, it is necessary to listen to the perspectives of governments and stakeholders other than just those in the countries and regions where the measures are being implemented, and reflect their views in the measures.

Having gained the basic understanding of the issues described above, the Japanese business community has several concerns especially as described below about the current discussions regarding sustainable finance mainly in the EU and, in particular, the issue of taxonomy. Government officials in the countries concerned, including the EU and Japan, are expected to carefully consider and take appropriate actions in order to realize global sustainable development.

1. Decisions regarding what is considered “sustainable” should be based on comprehensive evaluation, not solely on the environmental aspect

Climate action, one of the 17 Sustainable Development Goals (SDGs), is an important challenge that needs efforts by the entire world. At the same time, it is required to simultaneously achieve other SDGs that are closely linked to climate action, such as “affordable and clean energy” and “decent work and economic growth”.

While the recent EU Taxonomy Technical Report mainly focuses on the “mitigation” aspect of climate change, it states that other environmental areas, such as resource circulation and ecosystems, cannot be adversely affected (“do no significant harm”) in order for the economic activity, technology, or product in question to be classified as “sustainable”.

However, only focusing on the environmental aspect when deciding a specific economic activity, technology, or product as “sustainable” is not appropriate from the perspective of realizing much

wider ranging SDGs. In addition to the environmental aspect, this decision should be based on comprehensive evaluation that considers multiple factors, such as ensuring a sound balance of the S+3E in energy policy (**S**afety + **E**nergy Security, **E**conomic Efficiency, and the **E**nvironment), as well as feasibility and dissemination potential of the technology or product in question. In particular, if tradeoffs exist between different objectives that meet the definition of "sustainable", decisions ought to refrain from prioritizing any particular objective, but rather secure a balance among multiple objectives.

2. Business-led disruptive innovation should not be stifled

As stated in the Japan's long-term strategy under the Paris Agreement, the key to global and long-term climate action is business-led disruptive innovation.

What will lead to disruptive innovation is not predictable. Above all, ensuring the sound balance of the S+3E in energy policy is indispensable for realizing a vibrant economy and society, and it is necessary to keep all options available from the present to the future. Arguments in favor of arbitrarily eliminating specific economic activities, and the use of technologies and products, particularly fossil fuel, will elicit "credit withdrawals and credit crunches" and divestments by financial institutions and investors. These arguments are not appropriate, as they will hinder companies' R&D, as well as capital investments, and thereby stifle innovation.

The EU taxonomy, currently under discussion, is positioned as a "green list" exclusive to economic activities, technologies, and products that "contribute to climate change mitigation" and that must meet certain criteria and thresholds to be deemed "sustainable". However, fixing the "green list" in advance may hinder investments toward improving the energy efficiency and low-carbonization of existing technologies and facilities, and even stem disruptive innovation, which cannot be listed preemptively.[1] As explained earlier, whether or not economic activities, technologies, and products are "sustainable" should be determined from the perspective of achieving a wider range of SDGs. Thus, sustainable finance ought to lead to the mobilization of funds for "any investment opportunities that improve the status quo", moving forward to achieve the SDGs.

Moreover, if the EU taxonomy's narrowly defined "green list" leads to a discussion regarding the creation of a "brown list"—which places a reputational risk on specific economic activities, technologies, and products— then companies and financial institutions will lose their willingness

[1] According to the "2°C scenario" (Sustainable Development Scenario) in the IEA's World Energy Outlook 2018, it is estimated that, from the year 2018 to 2040, a total global investment of 16 trillion US dollars is necessary to achieve energy savings envisaged. It is assumed that this scale of investment can be only achievable by fully mobilizing investments toward all technologies and facilities that lead to energy efficiency improvements from the status quo without limiting to specific "green" technologies.

to invest, and this may damage the “virtuous cycle of environmental protection and economic growth” through innovation. The Japanese businesses clearly object to such arguments.

It is desirable that taxonomy would be intended not to preemptively fix specific economic activities, technologies, and products, but rather limit itself to indicating “examples” available at this point in time. With respect to the examples of activities, technologies, and products, the taxonomy would not narrowly define absolute criteria and thresholds, but rather encompass in its scope the relative degree of improvements in energy efficiency of technologies and products in question, as well as the substantial effects of climate action, taking into account specific circumstances of the regions and sectors concerned. This would hopefully draw out investments in a wide range of technologies and facilities, as well as a willingness to innovate. It should be noted that, in the first place, what should be assessed toward the realization of the goals of the Paris Agreement is the level of progress for the goals rather than the static level at a given point in time.

Additionally, while the current EU taxonomy proposal defines what is “sustainable” by focusing only on the efficiency level of individual technologies for each sector, environmental loads such as greenhouse gas emissions should not be limited within each individual sector. Rather, evaluation of the entire value chain, comprised of the production, distribution, utilization, disposal, and recycling of products, is important. For example, products that have somewhat high environmental loads associated with production, but have lower environmental loads during their utilization are considered sustainable. Conversely, products that have low environmental loads during utilization, but have greater environmental loads during the stages of production and disposal cannot be said as sustainable. As such, to make taxonomic decisions about individual technologies, it is necessary to conduct comprehensive environmental evaluation, taking into account of the entire life cycle and value chain of products that use those technologies.

3. The taxonomy should not rush to be internationally standardized or utilized for international financial regulations

The fundamental concept of taxonomy may be commonly shared worldwide; however, the specific criteria for eligibility should be set in a flexible manner by each country depending on its circumstances.

Currently, there have been some developments in discussion by entities such as the International Organization for Standardization (ISO) regarding the international standardization of the EU taxonomy. However, the current taxonomy has not adequately reflected the different views of non-EU countries, whose stages of development, geographical conditions, energy situations, and other factors of each country differ greatly. Thus, there is a risk that international standardization and uniform application of the current taxonomy to all countries could interfere with global

sustainable development, including in developing countries. Because of the above, the Japanese business community strongly opposes this international standardization and its uniform application.

Moreover, in the international Basel Accords that set the standards for the capital ratios of banks as well as in relevant regulations in each country and region, there have been some arguments in favor of utilizing the EU taxonomy for calculating the risk weights of assets (e.g. , arguments to reduce the risk weights for green assets, and raise the risk weights for brown assets). However, based on the same reasoning described above, such arguments are not appropriate. To begin with, climate change is only one of various financial risks, and its priority over other financial risks and its quantitative impact is not currently self-evident. Furthermore, there is no guarantee that the so-called “transition risk” arising from climate action will be uniform throughout the world because this risk depends on the strength and pace of introduction of policies in each country or region. Given these circumstances, to utilize the EU taxonomy for financial regulations of banks and other financial institutions will not only excessively burden bank management, but also amplify the systemic risks of financial institutions, thereby destabilizing international financial markets.