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Addressing the 'winner-takes-all' character of sustainability taxonomies

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Abstract

Sustainability classification systems (or 'taxonomies'), of which the EU environmental taxonomy is the most important, often result in a binary approach whereby best-in-class economic activities are qualified as sustainable, while all other activities are grouped together into one catch-all category irrespective of their contribution to, or potential for, furthering the transition towards a sustainable economy.

Such binary approaches are misleading and likely to result in under-investment in both crucial transition activities and innovation with the potential to further pro-environment transition. Making taxonomies easy to apply, consistent, open to innovation and comprehensive at the same time is imperative if the world's economies are to achieve net zero, even when this dilutes technical precision in the process. We argue in favour of expanding classification systems to include information on transition and potential transition activities, and present a scorecard approach to meet that very objective.

Keywords: taxonomies, environmental taxonomy, sustainability, ESG, rules-based approach, scorecard approach.

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1. Introduction

Classification systems, often referred to as 'taxonomies,' are key tools of contemporary sustainable finance regulation that enable the identification of sustainable (or green) activities, rather than depending on case-by-case decisions with uncertain outcomes (European Commission, 2018).

Taxonomies may be understood as 'a set of criteria which can form the basis for an evaluation of whether and to what extent a financial asset can support given sustainability goals' (Ehlers et al., 2021). They are meant to identify 'activities, assets, and/or project categories that deliver on key climate, green, social or sustainable objectives with reference to identified thresholds and/or targets' (ICMA, 2020). Investments funding such activities and projects are thus labelled as 'green' or 'environmentally sustainable.'

Taxonomies encourage investments in longer-term and sustainable activities for three reasons. First, the granting of a green or sustainability-related label by regulators is a powerful marketing tool that may spur investors' interest. Second, taxonomies that are part of binding legislation motivate more equal treatment in a finance industry notorious for 'greenwashing' (Delmas & Cuerel Burbano, 2011; Bodellini, 2023). In particular, they restrict room for manoeuvre opened by broad, originally undefined terms (such as 'sustainable' or 'green'), and thus boost investor confidence in market-based financing of sustainable activities. Third, from an investor perspective, taxonomies reduce transaction costs. Specifically, financial institutions do not need to build expertise in environmental science nor scrutinise the environmental footprint of a given activity (for instance, a construction project); they can rely on the taxonomy instead.

From a policy perspective, the establishment of a taxonomy should be based on two main considerations: i) the role that it is expected to play in the achievement of environmental objectives; and ii) usability and implementation factors, such as geographical scope, data availability, verification and proportionality (OECD, 2020).

Once developed, a taxonomy might even find broader application, for instance as a precondition for preferential tax treatment, sustainability-oriented public lending and investment programmes (such as the European Investment Bank's Green Gateway Programme), risk management and financial institutions' prudential (i.e. capital) requirements. Illustratively, financial institutions in Malaysia use the taxonomy to classify their portfolio of assets, measure climate-related risks and report to the central bank for risk management purposes (ICMA, 2021).

While taxonomies have taken centre stage in sustainable finance regulation (Busch, 2022; Colaert, 2022), the scholarship on classifying economic activities on these grounds is still in its infancy (Zetzsche et al., 2022b; Busch et al., 2021; Bodellini & Singh, 2021; Gortsos, 2020).

This article addresses one pain point relating to taxonomies: with the EU environmental taxonomy as the most influential example, classification systems may result in binary selection if they only classify best-in-class activities or projects as sustainable. These taxonomies exhibit what we label herein a 'winner-takes-all' character: niche industries that already meet the highest standards are labelled sustainable, while little or no information is provided on activities that do not meet those standards (yet). Such binary taxonomies do not distinguish between: a) activities crucial to the transition towards net zero; b) activities that do not have any relevant environmental impact (positive or negative); and c) truly harmful activities (i.e. those of hard polluters), regardless of whether these can be transformed into

sustainable activities or not. All of these diverse activities are grouped together into one residual category, sending a blurred signal to the market that potentially results in under-investment in the transition activities crucial to transform economies towards a net zero.

This article takes on binary taxonomies as follows: Part 2 provides context on classification systems; Part 3 critically analyses the binary effect of taxonomies; Part 4 introduces, as an alternative legal design of classification systems, the so-called 'Scorecard Approach'; and Part 5 concludes.

2. Defining Classification Systems

Taxonomies can be classified on several grounds, as laid out in Table 1 below.

Table 1 Categories of sustainability taxonomies

Features	Factor 1	Factor 2	Factor 3
Precision of screening criteria	Rule-based	Principle-based	Mix
Legal character	Binding	Voluntary	Comply *vs* explain
Time of assessment	*Ex ante* classification	*Ex post* classification	Upon application
Scope	Omni-comprehensive (all activities)	Industry-specific (e.g. only oil and gas sector)	Impact-specific (E,S,G)
Implementation and development	Legislation	Expert group	Industry
Information	Binary (sustainable yes/no)	Multiversal (e.g. transition strategy?)	

The aforementioned features may be combined; for instance, an expert group may perform an assessment upon the application of an industry participant interested in a given investment or asset class,

resulting in not only the gleaning of information on the investment, but also the setting of rule-based criteria for future assessments.

While these taxonomies share the objective of providing legal certainty on what economic activity is sustainable, we explore in this section the main categories to be considered by policy makers.

2.1. *Ex ante* or *ex post* taxonomies

Taxonomies can be set up as *ex ante* systems, whereby the criteria and/or thresholds for assessing economic activities are provided in advance through detailed provisions embedded in legislation and/or regulation (Zetzsche et al., 2022c).

For instance, the main principles of the EU environmental taxonomy have been codified in EU legislation, while the implementing details (called 'technical screening criteria') have been included in delegated legislative acts (i.e. sub-level legislation). The EU environmental taxonomy is often regarded as both innovative and demanding: to be deemed sustainable under EU law, economic activities need not only to provide a substantial contribution to one (of six) environmental objectives,[i] but must also avoid doing significant harm to any of the other five environmental objectives *and* comply with minimum social safeguards resulting from international frameworks on labour standards and human rights (Gortsos & Kyriazis, 2023). The EU environmental taxonomy shall serve as a role model for other jurisdictions, reflecting the 'Brussels Effect' (Zetzsche et al., 2022b). So far, examples to have followed suit include the UK's green taxonomy, Bangladesh's sustainable finance taxonomy as well as the taxonomies of Singapore and South Africa (ICMA, 2021).

A pre-defined classification potentially results in a high level of transparency and increased legal certainty. On the other hand, including every economic activity pursued in a given country would be excessively costly and would require enormous scientific expertise in many sectors, despite many activities impacting on the environment only to a minor extent. In turn, *ex ante* taxonomies may be limited in scope and focus on those activities which are responsible for the highest levels of pollution, such as oil and gas.

To save costs, taxonomies could be set up as *ex post* systems, whereby a decision on the sustainability of a given activity is taken by a review board or an authority upon request of interested stakeholders or investors interested in 'green' portfolios. Following this approach, legal certainty is provided case-by-case, and against a set of requirements that will be gradually developed further with each decision taken. The main drawback of an *ex post* classification is the low level of transparency, from an *ex ante* perspective, at least initially, and thus an enhanced degree of risk from both the investee firm's and the investors' perspective. An *ex post* system could potentially work in close supervisory relationships, as is the case between a central bank and commercial banks; use cases here include those concerning the institution-specific additional risk cushion (as found in Pillars II and III under the Basel Framework) and those regarding refinancing operations with an environmental footprint (Zetzsche et al., 2022c).

2.2. Detailed or principle-based taxonomies with either binding or non-binding provisions

A taxonomy can be set up in such a way as to provide very specific and detailed requirements concerning the environmental performance of economic activities, with the latter having to meet all such

requirements in order to be labelled sustainable. Such requisites might be quantitative (for example, absolute or relative performance thresholds), or qualitative and process-based (ICMA, 2021). Pertinently, the EU taxonomy's technical screening criteria define the maximum energy or water usage for a large number of activities.

Though offering precision, detailed quantitative thresholds are costly to develop, and expensive for end users to abide by. At the same time, the overall impact of such thresholds is uncertain as activities deemed sustainable may still have an effect on the environment and any subsequent adaption thereto would require regulatory intervention. While costs might discourage users, the rigidity of the thresholds limits the system's ability to adapt and correct unwanted effects.

By contrast, a taxonomy can provide some broad overarching principles. While detailed thresholds may be set out for some key matters, a certain degree of discretion may be assigned to users by clarifying that the general principles are paramount (Zetzsche et al., 2022c).

2.3. Binding, non-binding or 'comply or explain'

Taxonomies can have binding or non-binding effect. Where enforcement is desired, the classification must of course be binding. Moreover, a binding taxonomy could act as an effective tool to combat greenwashing practices (Zetzsche & Bodellini, 2022).

However, a non-binding taxonomy may also have a positive impact on the standardisation and streamlining of terminology with respect to determining which investments are 'sustainable,' 'green' or 'environmentally friendly,' while avoiding undesirable formalism.

A mix of binding and non-binding features is also an option. For instance, issuers may opt-in to the EU Green Bond Standard; if they do

so, however, they must comply with all rules set for EU green bonds. An alternative to the opt-in binding effect is known as 'comply or explain' where issuers may deviate from the taxonomy, but must disclose and explain their deviation. 'Comply or explain' thus contributes to a better understanding of the limits and practical acceptance of taxonomies.

2.4. Scope

Other forms of taxonomy as determined by their scope are discussed below.

2.4.1. All-inclusive, industry-specific or impact-focused taxonomies

A taxonomy could in theory aim to serve as an all-inclusive classification system encompassing every economic activity in a given country, if not the world. Obviously, such all-inclusive classification would require unrealistic levels of regulatory capital and scientific expertise. Even where enormous resources are invested they may still be insufficient, and thus an omni-comprehensive taxonomy carries the risk of the misallocation of capital resulting from a lack of regulatory resources, expertise and data on sustainability as well as clouding future developments with uncertainty (Zetzsche & Anker-Sørensen, 2022).

An alternative is a partial taxonomy focused on certain industries (such as heavily polluting oil and gas activities) or specific impacts of high importance (such as greenhouse gas (GHG) emissions, or social inclusion). Initially, regulators could also take a small and focused approach, and then expand the taxonomy's scope over time as successes are recorded and ambition grows.

2.4.2. Environmental-only, social-only or environmental and social taxonomies

As for the subject(s) they cover, taxonomies can deal either with environmental matters only, social matters only, or both environmental and social matters. While most taxonomies so far have focused exclusively on environmental matters, the discussion regarding social taxonomies is gaining momentum as greater consideration is afforded to the interrelationships between environmental and social objectives (Platform on Sustainable Finance, 2022b). In particular, the case has been made that making advances on social objectives is a precondition for long-term progress on environmental objectives because social cohesion facilitates long-termism among economic actors (Arner et al., 2020).

Since taxonomies can help to channel investments towards some specific economic activities, a taxonomy with a broader scope is better placed to attract greater financial resources. In particular, social progress may be financed in this way which represents a crucial precondition for sustainable development in some regions of the world (Zetzsche et al., 2022a).

2.4.3. From small to large

Due to the significant costs of large-scope taxonomies, most regulators start small and expand their scope over time. For instance, the EU environmental taxonomy focused first on six environmental objectives (which meant postponing work on social objectives), and then narrowed this down to two environmental objectives referred to as 'climate objectives,' namely climate change mitigation and climate change adaptation. Accordingly, in line with the EU's strategic policy, the Commission has prioritised climate change and devised the corresponding detailed technical screening criteria. Yet the Commission's agenda foresees expansion of the framework into four

other environmental objectives (water and marine resources; transition to a circular economy; pollution prevention and control; and biodiversity and ecosystems) as well as social objectives.

3. Issue: the binary effect of taxonomies

3.1. Binary *vs* transitory approach

Taxonomies can be binary or transition-focused.

Binary taxonomies highlight activities with the strongest environmental performance, while all activities with weak or relatively weak performance end up in the 'non-compliant' category. Meanwhile, taxonomies that are transition-focused provide information on economic activities that do not show a high level of environmental performance but do have the potential to do so, along with low-impact or environmentally neutral economic activities and environmentally harmful activities.

For instance, EU and EU-style taxonomies adopt a binary approach that focuses on best-in-class activities, whereby only activities that further one environmental objective without doing significant harm to the other five, and that meet the minimum social safeguards, qualify as sustainable. Notwithstanding the former, EU law asks large issuers to disclose revenues, operating expenditures (OpEx) and capital expenditures (CapEx) concerning sustainable activities. If an issuer discloses a share of higher CapEx than OpEx, the European Commission understands this as signal for transition (European Commission, 2023).

Against this background it is surprising that the EU's very own expert body argues that the inclusion of transitory activities and data on non-performing activities with the potential to upgrade their

environmental performance is crucial to making the transition to net zero (Platform on Sustainable Finance, 2022a). We take this apparent tension between EU legislation and expert opinion[ii] as our motive for taking a closer look at binary taxonomy approaches in the next section.

3.2. Upsides of binary approaches

Binary approaches have obvious advantages with regard to regulatory costs. Agreeing on and legislating for only best-in-class activities is less expensive than also agreeing on details and quantitative thresholds for many additional (at least four more) categories on various environmental objectives. For that reason, best-in-class taxonomies can be more granular, and may provide greater legal certainty within their limited scope.

A binary approach also faces less political resistance as heavy polluters may argue that they have the potential to enhance their performance and would improve in the future, or, as is the case for the oil and gas sector, that they are crucial with regard to the transition to net zero. Heavy polluters cannot opt for such a stalling strategy where taxonomies provide reliable information on transition strategies and investments.

3.3. Drawbacks of binary approaches

At the same time, taking a binary approach may have several drawbacks.

3.3.1. Misleading signals

Firstly, limited scope could impair the taxonomy's function and ability to deliver on its goals: all economic activities that are not best-in-class are grouped together in a residual and catch-all category of activities, which would potentially be perceived on the market as non-sustainable. This category includes activities with very different

environmental performance. However, sending out a signal of being non-sustainable could be misleading, since some activities that are close to being best-in-class, or at least have the potential to become best-in-class, are presented in the same category as activities with no environmental impact (such as accounting and legal services, childcare, travel services, health services and education, which together make up one-third of the EU economy) and clearly polluting activities (e.g. those based on fossil fuels).

Accordingly, fossil-fuel-based power generation would be placed in the same category as construction of new buildings which complies with almost all of the very demanding criteria of the Commission Delegated Act concerning energy performance, air-tightness, thermal integrity and life-cycle global warming potential, or complies with all said requirements but fails to adhere to the DNSH principle in relation to sustainable use of water (e.g. the installed showers have a water flow of 9 litres per minute, which is above the EU threshold of 8 litres per minute). The outcome is clearly disproportionate: three economic activities that are ontologically different in environmental performance are grouped together, and thus potentially perceived as equally non-sustainable.

3.3.2. Underfunding of transition activities

To unpack the misleading signals, investors need to spend significant resources. The transaction costs involved here make investments in transition activities more expensive than would be desirable, which may result in potential underfunding of transition activities.

With such a scenario in mind, a binary approach with its inherent ‘winner-takes-all’ character does not provide the necessary incentives for businesses to improve their environmental performance gradually in a so-called race to the top, which is imperative if the transition to net zero is actually to happen (Platform on Sustainable Finance, 2021).

To date, most green finance investments have been allocated to economic activities which are already low-carbon, while substantially fewer investments have been made in transition and enabling activities in carbon-intensive industries such as oil and gas, mining and heavy industry (Ehlers et al., 2021). It is here, however, where most progress can be made as these transition activities have become indispensable, irrespective of their impact on environmental factors. In fact, according to the Platform on Sustainable Finance, 'many sectors of the economy…must transition to more sustainable models even if they cannot reach the green performance level defined by [best-in-class] taxonomy criteria' (Platform on Sustainable Finance, 2022a).

3.3.3. Expanding the "green asset" bubble

Thirdly, in the EU, currently only a tiny percentage of economic activities meet the criteria for making a substantial contribution to an environmental objective and the criteria determining adherence to the DNSH principle with regard to any other environmental objective, both of which are required to qualify as environmentally sustainable. With most investment opportunities thus left aside due to not qualifying as sustainable, financial regulation artificially inflates the value of those financial instruments issued by the few businesses which do comply with the taxonomy criteria due to the increasing market appetite for sustainable investments.

3.3.4. Lack of support for impact investors

Fourthly, as things stand, best-in-class taxonomies do not act as meaningful tools for impact investment. To clarify, impact investment has two main components: 1) investor impact; and 2) investee company impact. While investor impact is typically understood as the change that the investor causes in its investee company's activities (for example, through an increase of green power production resulting

from activism and engagement), investee company impact refers to the change that such a company has made in the world (for instance, through the environmental benefit arising from a GHG emissions reduction) (Baadj et al., 2021).

The EU taxonomy only identifies environmentally sustainable activities, thereby failing to consider the role of (impact) investors in causing a beneficial environment-related change in their investee companies. In other words, impact investors investing in companies making a negative environmental impact (e.g. heavy polluters) with the goal of making them improve are currently excluded from the taxonomy's disclosure effects.

A taxonomy should incentivise improvements to reach its thresholds in line with the goal of transitioning to net zero. Moreover, it should facilitate the environmental improvement of any economic activity, except for those economic activities which, by their very nature, cannot avoid harming the environment and where their environmental impact cannot be reduced. In turn, we find the best-in-class taxonomies to be sub-optimal, which prompts us to look for better solutions, as outlined in the next section.

4. Solution: "scorecard approach"

While most taxonomies are tailored towards best-in-class activities as this article has shown, some go beyond that to seek out more transitory activities. For instance, the Singapore taxonomy relies on a traffic light system to address transition matters. Meanwhile, South Africa has developed a brown taxonomy, highlighting environmentally harmful activities (ICMA, 2021). In a similar vein, the UK announced that it will set sustainability criteria for both transition-based and best-in-class activities and investments.[iii]

Furthermore, the EU is seeking to support the transition to net zero by expanding its taxonomy framework, by adopting best-in-class criteria for the "transition to a circular economy" in the "Environmental Delegated Act (European Commission, 2023a) and issuing a transition-related recommendation drawing on revenues, operating and capital expenditures in June 2023 (European Commission, 2023b).

It is obvious that policy makers pay close attention to how taxonomies can best inform market participants in their decisions to allocate capital to transition activities or not. We argue in this section that the best way to avoid the effects of binary taxonomies is by providing more information to market participants on all ESG criteria as well as on transition, courtesy of what we call a "scorecard approach." Besides best-in-class criteria, the envisioned scorecard encompasses, criteria for activities with lower and very low ESG performance, as well as data on transition-focused strategies.

Figure 1 below shows scores which could be assigned according to our scorecard approach, based on an example focusing on energy generation.

Figure 1: Scorecard example for electricity generation from renewable non-fossil gaseous and liquid fuels

Quantitative thresholds: Life-cycle GHG emissions	Main factor qualification	Contribution to climate change mitigation	DNSH	MLSS	Transition strategy	Score	Investment label	Impact on climate change
<100 g CO 2 e/kWh	Best-in-class	Substantial contribution	+	+	n.a.	9	Environmentally sustainable	n.a.
			-	+	Y	8A		
					N	8B		
			+	-	Y	7A		
					N	7B		
			-	-	Y	6A		
					N	6B		
100 to 120 g CO 2 e/kWh	Environmentally beneficial	Positive contribution	+	+	Y	5A	Environmentally beneficial	medium low*
					N	5B		n.a.
			-	+	Y	4A		medium low or n.a.
					N	4B		n.a.
			+	-	Y	3A		medium low or n.a.
					N	3B		n.a.
			-	-	Y	2A		medium low or n.a.
					N	2B		n.a.
n.a.	Environmentally neutral	Zero contribution	n.a.	n.a.	1	1	Environmentally neutral	n.a.
> 120 g CO 2 e/kWh	Environmentally harmful	Harmful impact	n.a	n.a	Y	0A	Environmentally harmful	High
					N	0B		n.a.

Legend: 1) **DNSH:** compliance with the 'do no significant harm' test; 2) **MLSS:** compliance with minimum legal and social safeguards; 3) **Transition strategy**: the category signals that an issuer has adopted a transformative strategy aimed at transition towards best-in-class requirements in the future; and 4) **Impact**: relevance to impact investors (focus: climate change).

4.1. Introducing the "scorecard approach"

Under the scorecard approach, economic activities are scored based on a more granular system of environmental thresholds, compared to the aforementioned technical screening criteria. Based on the example of the EU environmental taxonomy, by assigning scores to information providers, which are usually the issuers of a financial product, it could be possible to distinguish between (the already existing concept of) substantial contribution to an environmental objective, and the new concepts of contribution to an environmental objective and harmful impacts on an environmental objective. Furthermore, for neutral activities such as education and legal services, their neutrality can be displayed by assigning a separate score, indicating that no impact has either been claimed or achieved.

In our scorecard system, the EU's technical screening criteria for determining the extent to which an economic activity contributes to (or negatively affects) an environmental objective provide the basis for the scores, which are broken down as follows.

- 'Environmentally harmful' activities: score of 0.
- 'Environmentally neutral' activities: score of 1.
- 'Environmentally beneficial' activities that make contributions to an environmental objective, albeit not to a significant extent: scores between 2 and 5.
- 'Best-in-class' activities: scores between 6 and 9.

In addition to the broad ranges of factors that feed into the labelling of a particular investment, the scores also provide information as to why a given activity falls short of being best-in-class: failing the "do no significant harm" (DNSH) test reduces the score by one (resulting in scores of 8 or 4 respectively), while failing the "minimum legal and social safeguard" (MLSS) test reduces the score by two (resulting in

scores of 7 or 3, respectively), and failing both the DNSH and MLSS tests would reduce the score by three and result in a score of 6 or 2, respectively.

In addition, the given score could indicate whether the information provided is static or whether the issuer has adopted a transition strategy that should push the current level of environmental performance towards best-in-class. This information is important for impact investors seeking to make a change through their investments. In our example, A signals the existence of a transition strategy. For instance, 8A signals that an activity scores very high for its contribution to one environmental objective, yet fails the DNSH test (i.e. it impacts significantly on a different environmental objective), but the issuer seeks to change this impact and has adopted a formal strategy (including an investment plan) aiming to pass the DNSH test in the foreseeable future as further disclosed in the plan. Accordingly, static investments (which receives a score of B) are separated from dynamic investments (scoring at A). Depending on the reason(s) why an activity fails to obtain best-in-class status, a transition plan may accommodate some but not all of the issues. For instance, an activity scoring 6 (i.e. making a significant contribution, yet failing the DNSH and MLSS tests) may seek to bring its supply chain in line with the OECD Guidelines for Multinational Enterprises as well as the labour standards of the International Labour Organization (ILO), to upgrade its score to 7. The quality and feasibility of the transition strategy itself, however, must be assessed by impact investors.

Our scorecard sheds significant light on meaningful (though not substantial) contribution to environmental objectives (score between 2 and 5), including as to whether they pass the DNSH and MLSS tests. This information is, so far, entirely missing under the EU taxonomy framework, yet it provides the strongest signal of potential for change: if an issuer can upscale its contribution, it would score much higher

(perhaps even 9, if it passes the DNSH and MLSS tests). Through the proposed scorecard approach, such medium contribution to an environmental objective is recognised in the legal framework. In turn, investments funding such activities would be given a label which could attract investors. This label is expected to provide an incentive to further their environmental contribution on the grounds that several activities cannot meet high thresholds overnight, yet their significant improvement might represent a relevant contribution to the transition to net zero and thus deserve investments.

In Figure 1, we set out the scores for power generation from renewable non-fossil gaseous and liquid fuels where life-cycle GHG emissions are just above the threshold of 100 g CO2 e/kWh, but below 150 g CO2 e/kWh. Even where the demanding criteria set by the EU taxonomy are not met, such an activity could still perform better than many others in the field (such as burning coal) and pass both the DNSH and MLSS tests. This comparatively good performance could be recognised in our scoring system and ensure that investing in this technology is incentivised through better access to finance.

The clear identification of environmentally harmful activities would help channel investments toward those where investments would finance a transition strategy and thus contribute toward the transition to net zero, while proportionally reducing investments in detrimental activities where the negative impact cannot or will not be reduced. Where there is potential for improvement, financing the transition (i.e. providing funds to stop the activity as it is currently performed by way of substituting it with a less harmful approach) may help the environment much more than financing best-in-class activities only and driving up the prices in this asset class even further.

In a similar vein, the creation of an additional category of activities which are environmentally neutral would clarify that while they do not

provide any meaningful contribution to the achievement of environmental objectives, they do not harm such objectives either. Such activities would primarily be in the service sector, legal services, accounting and tax-related services, childcare and education. This clarification would allow these activities to be properly distinguished from environmentally harmful activities, which would mark an important step toward access to finance of these activities; after all investments into (e.g.) education is a precondition for any innovation.

Our scoring system is designed to demonstrate how scores can make investors' choices more effective through reduced transaction costs. Obviously, the score itself may be modified or supplemented by additional information. For instance, we could envision additional symbols for other economic objectives being considered (such as I to VI to reflect the EU's six objectives). We could also foresee the use of numbers indicating issuers' estimate on how many years it will take them to bring an activity in line with the next best activity. A score of 0A3 would signal that a currently harmful activity shall be environmentally beneficial in three years, while 5A2 would signal that the issuer plans to provide significant contributions two years from now (if properly funded). Finally, additional numbers could signal interdependencies with other economic activities; where one activity is undergoing change, another may subsequently be able to follow.

All in all, a scorecard system has the potential to display a wide array of performance bandwidth, enables controls on the side of impact-oriented investors, and also carries the potential for change in a way best-in-class taxonomies are unable to provide.

4.2. Advantages

Considering the additional categories of environmental performance and the provision of more information on transition could encourage market-based competition for sustainability. In particular, impact investors will seek out financial products where issuers promise change – and may scrutinise the management's performance based on the changes to take place between the time of the promise and the estimated time of delivery. Issuers are encouraged in this way to respond to investors' demands. This stands in stark contrast to the currently prevalent practice where performance is measured only abstractly against a benchmark set by regulators that does not consider the truly harmful (or "brown") activities.

The proposed scoring system enables measurement of the degree of planned contribution to environmental objectives made by any given economic activity. This in turn would allow for the building of a more granular measurement system whereby, over time, every economic activity could be precisely rated for its contribution to environmental objectives, based on the issuer's own assessment. Accordingly, this would overcome the 'winner-takes-all' features of the EU environmental taxonomy, with the result being a scoring system that recognises the positive impact of change, irrespective of current environmental performance.

We foresee a number of positive side effects. For instance, financial institutions could improve their risk management policies based on better identification of transition risks. On top of that, public support programmes could be tailored to focus on financing the transition of the largest polluters, while environmental policies (through prohibitions and stricter standards) could focus on harmful activities where issuers do not signal any potential to change (i.e. where issuers do not disclose transition strategies).

At the same time, our scorecard approach avoids a main downside of a reporting-based transition system, like the EU's focus on revenues, operating expenditures (OpEx) and capital expenditures (CapEx) on sustainable activities: revenues, OpEx and CapEx reporting merely provides information on what has been done in the past reporting period. Transition finance, however, is about allocating capital to *future* transition projects that deserve financing – these future projects will not show in CapEx figures of the past.

4.3. Challenges

We admit that the scorecard approach comes with a number of challenges. In order for the scores to be sufficiently granular, more detailed and lengthier level 2 legislation might be required. Not only do we need criteria to define the best-in-class, but the (sometimes thin) line between (mere) contribution (with scores between 2 and 5) and harmful activities (with a score of 0) must also be defined. In fact, in light of the experience with the EU taxonomy which even years after its coming into force is still only being implemented gradually, any extension of the classification system might encounter resistance from market participants that suffer from high compliance costs imposed on them by earlier steps taken to define the "best-in-class."

Furthermore, clearly identifying environmentally harmful activities and singling them out for even more progressive steps in environmental law, could lead to the drying up of sources of financing for these activities. This could give rise to a significant surge of stranded assets in the portfolio of financial institutions or their counterparties, putting financial stability at risk. Any move toward a transition-focused sustainability classification system must thus be handled with great care.

5. Conclusion

Our article has contributed to the scholarship in three main ways. First, we have laid out the most viable options for designing a sustainability classification system. Second, we have revealed the risks associated with taxonomies that exhibit 'winner-takes-all' characteristics, which may be good for the 'winner' but bad for the environment. Resulting from the binary type of information provided, such taxonomies potentially result in the underfunding of transition where it is needed most. Third, with our scorecard approach we have provided an alternative classification system and shown how the scoring methodology could build on the information provided in the (rather binary) EU environmental taxonomy.

While we also acknowledge the challenges that come with any extended taxonomy, including economic activities falling slightly short of the best-in-class is essential if the taxonomy is to function smoothly and deliver on its goals. After all, a taxonomy should assist in funding the transition of the economy towards net zero.

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Endnotes

[i] The six environmental objectives embedded in the EU taxonomy are: 1) climate change mitigation; 2) climate change adaptation; 3) the sustainable use and protection of water and marine resources; 4) the transition to a circular economy; 5) pollution prevention and control; 6) the protection and restoration of biodiversity and ecosystems.

[ii] According to the European Commission, the binary effect will be mitigated by two factors. First, the EU plans to adopt technical screening criteria for transitional activities as activities for which there is no technologically and economically feasible low-carbon alternative. Important examples of transitional activities are included in the EU's Complementary Delegated Act concerning natural gas and nuclear energy relative to climate change mitigation. Second, the EU Commission understands the issuers' disclosure on the ratio of revenues, capex and opex as the issuers' commitment to transition to net zero. For these reasons, the Platform for Sustainable Finance (2022a) argues that the EU taxonomy is not binary in its effects. *But* see our counter-argument in 4.2.

[iii] See https://www.greenfinanceinstitute.co.uk/programmes/uk-green-taxonomy-gtag/.