From vision to reality: Circular Economy is an essential part of the EU Taxonomy

What does it mean for investors and companies?

SDiD data research supports investors and companies to mainstream Circular Economy and bring it to scale

For years, the financial sector has been integrating Environmental, Social and Governance (ESG) issues, such as climate change, water conservation, and human rights, in corporate decision making and investment strategies. Investors have been integrating these factors into their investment processes and valuations.

Asset managers globally are expected to increase their ESG-related assets under management (AuM) to US$33.9tn by 2026, from US$18.4tn in 2021, a PricewaterhouseCoopers study reveals. [1].

Implementing Circular Economy in corporate strategies has many co-benefits, such as GHG emissions reduction , biodiversity loss prevention and prevention of human rights issues in supply chains. In a nutshell, Circular Economy can improve ESG performance.

This white paper focusses on Circular Economy within the context of ESG investing and EU regulations aiming at a transition to an inclusive, low-carbon circular economy.

SDiD is a Circular Economy data boutique specializing in sustainability and resource strategy topics. We aim to help investors and companies to be ahead of their game and create a positive impact.

1. Definition of Circular Economy

Increasing global resource consumption and correlating environmental impacts are paving way for a shift towards lifecycle approaches to material use, resulting in the development and implementation of circular economy practices. The focus is on manufacturing and construction sectors due to the high level of resource use and material circularity potential.

Recognising the importance of shifting economic activities towards a circular economy, the European Commission, as part of its continued so-called EU Taxonomy for Sustainable Finance, published a set of technical screening criteria for making a substantial contribution to a transition towards circular economy.

According to the EU Taxonomy, 'circular economy' means an economic system where the value of products, materials and other resources in the economy is maintained for as long as possible, enhancing their efficient use in production and consumption, thereby reducing the environmental impact of their use, minimising waste and release of hazardous substances at all stages of their life cycle, including through the application of the waste hierarchy.

2. How does a Circular Economy relate to ESG?

Companies across various sectors are adopting circular economy principles to reduce costs, increase revenues and reduce risks. Besides the rise of companies adopting circular economy practices, the number of regulations related to circular economy are increasing too. In the U.S., California's Plastic Pollution Prevention and Packaging Producer Responsibility Act requires producers of single-use packaging and single-use plastic service ware to join a producer responsibility organization and sets targets for the recycling of plastic packaging manufactured or sold in the state. The EU is setting higher targets for recycled materials, with its amended Directive 94/62/EC on Packaging and Packaging Waste setting a mandatory 55% recycling rate for plastic packaging by 2030.

Circular economy concepts, when integrated within corporate ESG strategies, are a framework for improving sustainability and disclosing sustainability performance to investors and stakeholders. With the surge of ESG investing, fund managers need ESG data, including circular economy data, tools and analytics to aid decision making.

ESG investors consider a company's performance across E, S and G factors — alongside traditional fundamental analysis — when making investment decisions. If we look at circular economy, ESG investment frameworks require metrics, especially from product manufacturers. Investors will be seeking to understand whether product manufacturers and construction companies drive improvements and risk mitigation measures across each of the product lifecycle phases, ideally by disclosure in the ESG sense.

In order to achieve this, a common understanding, as well as clearly defined criteria and metrics, are needed. In the EU Taxonomy, activities that contribute to the transition to a circular economy are defined in order to direct capital flows into sustainable investments, enabling the transition.

3. The EU Taxonomy explained

The EU Taxonomy Regulation is a classification system for sustainable economic activities, which was published in June 2020. The overall goals of the taxonomy are to create transparency and disclosure for the impact of investments. Companies that fall under the regulation need to disclose to what extent their activities are aligned to the taxonomy. This information is needed by financial market participants that are offering sustainable finance products. With the information on what economic activities are sustainable according to the EU Taxonomy, sustainable investments can be made.

The EU Taxonomy established the following six environmental objectives to define what sustainable economic activities are:

1. Climate change mitigation
2. Climate change adaptation
3. Sustainable use and protection of water and marine resources
4. Transition to a circular economy
5. Pollution prevention and control
6. Protection and restoration of biodiversity and ecosystems

There are three general criteria to evaluate whether an economic activity is sustainable under the EU Taxonomy:

- Contribution to at least one of the six environmental objectives
- Doing no significant harm (DNSH) to any of the other five environmental objectives
- Compliance with minimum safeguards (e.g. OECD Guidelines on Multinational Enterprises, UN Guiding Principles on Business and Human Rights)

This means that companies are required to run activities that make substantial contributions to the different objectives. Through delegated acts, the EU Commission defined the technical screening criteria for each environmental objective resulting in a list of environmentally sustainable activities.

4. Circular Economy in the EU Taxonomy

The definition of the so-called ”Substantial contribution to the transition to a circular economy“ can be found in article 13 of Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020. [2]

To assess whether an economic activity contributes to the objective, the Platform’s Technical Working Group published its final recommendations on March 30th, 2022. These are the basis for a second delegated act covering the remaining four objectives, including objective 4 - transition to a circular economy. Here the Technical Working Group classified the following four categories to define substantial contribution to objective 4:

- **Circular design & production:** design and produce products and materials with the aim of retaining long-term value and reducing waste; promoting dematerialization by making products redundant or replacing with radically different product or service;
- **Circular use:** life extension and optimized use of products and assets during use phase, with the aim of retaining resource value and reducing waste to help improving usage and supporting service;
- **Circular value recovery:** capture value from products and materials in the after-use phase; and
- **Circular support:** develop enabling digital tools and applications, education and awareness raising programmes, and advisory services to support circular economy strategies and business models.

5. What do the banking supervisors say?

Transitioning to a low-carbon and more circular economy entails both risks and opportunities for the economy and financial institutions, while physical damage caused by climate change and environmental degradation can have a significant impact on the real economy and the financial system. Therefore, the European Central Bank (ECB) has identified climate-related risks as a key risk driver in the SSM (Single Supervisory Mechanism) Risk Map for the Euro area banking system. The ECB is of the view that institutions should take a strategic, forward-looking and comprehensive approach to considering climate-related and environmental risks. [3]

Sustainability risks are environmental, social or governance events or conditions, which, if they occur, have or may potentially have significant negative impacts on the assets, financial and earnings situation, or reputation of a supervised entity.

The BaFin believes that all ESG risks should be considered. The transition to a circular economy, the avoidance of waste, and recycling are explicitly seen as ESG risk factors by BaFin. [4]

The European Banking Authority (EBA) sets out guidance that banks should capture ESG information in their Loan Origination and Monitoring Guidelines. Necessary information for the calculation of the BTAR shall be obtained on a best effort basis in the context of the bilateral relationship with counterparties or, when needed, using estimates, without creating disclosure obligations to them. The EBA expects reliable data for the GAR (Green Asset Ratio) from December 2023 for counterparties subject to NFRD disclosure obligations and households. All companies that do not fall under the NFRD disclosure need to report on the BTAR (Banking Book Taxonomy Alignment Ratio) by June 2024. [5]

> “In asset and wealth management, where demand for ESG investment products continues to soar, more sophisticated ESG data enables firms to offer new funds, portfolio management services and support for DIY investors.”
>
> | **KPMG** - Closing the disconnect in ESG data

6. SDiD's contribution to assessment of market-readiness for Circular Economy within the EU Taxonomy

In order for financial institutions to evaluate whether companies in their investment portfolio are making a substantial contribution to objective 4 – the transition to a circular economy – comprehensive data-sets are needed. To minimize the effort for financial institutions, the external provision of data-sets focused on the Circular Economy (CE) performance of companies might be helpful. Through the collection of CE performance data (qualitative and quantitative), evaluations regarding the contribution of the economic activities of potential investments are made. The following table shows how the CE indicators aggregated by SDiD's CE data research are connected to the criteria of the EU taxonomy. The data allows financial institutions to assess whether a company's economic activity is EU Taxonomy aligned.

Graph: Mapping SDiD's Circular Economy indicators to the categories of the EU Taxonomy's objective number 4: Transition to a circular economy

Categories objective 4: Transition to a circular economy	SDiD CE indicators
Circular design & production: design and produce products and materials with the aim of retaining long-term value and reducing waste; promoting dematerialization by making products redundant or replacing with radically different product or service;	**CE program/strategy/process (yes/no):** Is a program or strategy or internal process on the topic circular economy (CE) visible?
Circular use: life extension and optimized use of products and assets during use phase with the aim of retaining resource value and reducing waste to help improving usage and supporting service;	**Total Waste (t):** All the waste that is generated – all types of disposal, all types of toxicity (e.g. hazardous + non-hazardous waste) **Waste recycling rate (%):** Percentage of waste that is recycled (incineration is not recycling)

Categories objective 4: Transition to a circular economy	SDiD CE indicators
Circular value recovery: capture value from products and materials in the after-use phase;	**Recycled/reused material input (%):** the percentage of material within the whole production that is recycled or reused input;
Circular support: develop enabling digital tools and applications, education and awareness raising programmes, and advisory services to support circular economy strategies and business models.	**Membership CE initiatives (yes/no):** Is the company part of an external organisation, initiative, association which focusses on circular economy? **Stakeholder engagement (yes/no):** Is there any activity (product, campaign etc.) which sensitizes or educates suppliers, employees, the public or customers regarding circular economy? **CE Group/Department (yes/no):** Does the company report about a working group, initiative or department within the company that is responsible for circular economy?

All four categories which define a substantial contribution to the transition to a circular economy, as outlined in the EU Taxonomy, are covered by SDiD CE research and in line with EBA requirements on capturing ESG data.

The CE data of SDiD will support financial institutions integrating CE performance and risks in portfolio management strategies. Potential examples of integrating CE research data (if relevant to the business model):

- Exclusion criteria/limits
- Positive lists
- Best-in-Class approach
- Specific characteristics
- Engagement
- Proxy voting

7. The SDiD Circular Economy offer

As a specialized Circular Economy research boutique, SDiD has developed core services based on our extensive research of Circular Economy data:

- **The SDiD Circular Economy platform** offers the possibility to compare and benchmark the CE research data from companies in different industries and regions.
- **The SDiD Circular Economy Score®** can be used to determine the sustainability of financial investments and, where applicable, to infer additional information regarding sustainability risks.
- Tailored **SDiD Circular Economy data** can be requested to fit your specific data requirements, qualitative and quantitative.
- SDiD Circular Economy services support investors and companies to mainstream the Circular Economy into business practice and bring it to scale.

SDiD contact information

sdid.eu

SD Identity UG (haftungsbeschränkt)
Veteranen Strasse 24
10119 Berlin

Erik van Buuren
CEO

E-Mail: info@sdid.eu