

EXPLORING THE IMPLEMENTATION OF THE EU TAXONOMY FOR FINANCIAL INSTITUTIONS

EUROPEAN TAXONOMY FOR SUSTAINABLE ACTIVITIES

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The birth of a general and structured regulation framing environmental performance of financial institutions creates a series of governance and practical questions within the industry. Its relative nascent stage requires an implementation far from traditional financial and risk reporting.

Banks and Insurances, among others, need to anticipate the role of all their business lines, their data and insurers their top governance management in this implementation.

The EU Taxonomy regulation, in force since June 2020, is considered as a general framework for this new type of reporting, but still leaves significant room for interpretation for applicants. The goal of this paper is not only to describe the features of this regulation, but also to provide concrete guidelines and areas of consideration to support financial institutions in their implementation path.

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1. Introduction

1.1 Context of the mandate of the Commission in terms of Sustainable Finance

In line with the goals of the Paris Agreement¹, the European Union launched the European Green Deal setting out the objectives² to achieve a carbon neutral economy by 2050. This European Green Deal is supported by the European Action Plan which aims to strengthen funding for sustainable growth with, among other actions³, the target to reorient capital flows towards sustainable investment.

The EU Taxonomy Regulation, published in June 2020, is part of those initiatives to foster sustainable investment.

1.2 Presentation of the Taxonomy

The EU Taxonomy⁴ is a tool for stakeholders to inform or be informed on activities which significantly contribute to sustainable development. It represents a classification system which aims to establish six environmental objectives as contributing to the transition to a more sustainable economy:

- Climate change mitigation;
- Climate change adaptation;
- Sustainable use and protection of water and marine resources;
- Transition to a circular economy;
- Pollution prevention and control;
- Protection and restoration of biodiversity and ecosystems.

It defines activities in 9 macro sectors⁵ which are established as contributing to the climate change mitigation and adaptation objectives (the four other objectives will be further addressed in the incoming regulations). When defining the EU Taxonomy alignment, economic activities are structured around the EU's NACE industry classification system⁶. To be considered as environmentally sustainable (and thus aligned with the EU Taxonomy), an activity must respect the following four specific criteria linked to the above-mentioned objectives:

- (1) Make a substantial contribution to at least one environmental objective

This is the first necessary condition to qualify as Taxonomy-aligned. It ensures that the activity significantly either has a positive environmental impact or reduces environmental negative impacts.

¹ The Paris Agreement is the global climate change agreement adopted in 2015. It defines a global framework to prevent the negative impacts of global warming by limiting the rise of temperatures to maximum 2° C. It is legally binding for the countries who signed it. Paris Agreement. (2019). Climate Action - European Commission. https://ec.europa.eu/clima/policies/international/negotiations/paris_en

² "First climate action initiatives under the Green Deal include: European Climate Law to enshrine the 2050 climate-neutrality objective into EU law; European Climate Pact to engage citizens and all parts of society in climate action; 2030 Climate Target Plan to further reduce net greenhouse gas emissions by at least 55% by 2030; New EU Strategy on Climate Adaptation to make Europe a climate-resilient society by 2050, fully adapted to the unavoidable impacts of climate change." EU climate action and the European Green Deal. (2019). Climate Action - European Commission.

³ The three categories of actions defined in the Action Plan are : Reorienting capital flows towards a more sustainable economy, Mainstreaming sustainability into risk management, Fostering transparency and long-termism. *Renewed sustainable finance strategy and implementation of the action.* (n.d.). European Commission - European Commission.

⁴ The TEG - Technical expert group on sustainable finance - helped the European Commission to develop the EU Taxonomy. It is according to its work that criteria and definitions were chosen to be part of the EU Taxonomy Regulation.

⁵ Forestry; Environmental protection and restoration activities; Manufacturing; Energy; Water supply, sewerage, waste management and remediation; Transport; Construction and real estate activities; Information and communication; Professional, scientific and technical activities.

⁶ "NACE is a four-digit classification providing the framework for collecting and presenting a large range of statistical data according to economic activity in the fields of economic statistics and in other statistical domains developed within the European statistical system (ESS)" *Glossary: Statistical classification of economic activities in the European Community (NACE) - Statistics Explained.* (n.d.). Eurostat Statistics Explained.

TABLE 1: Explanation of substantial contribution to the environmental objectives.

ENVIRONMENTAL OBJECTIVES	EXPLANATION OF SUBSTANTIAL CONTRIBUTION TO THE ENVIRONMENTAL OBJECTIVES ⁷
Climate change mitigation	<i>The activity contributes substantially to stabilise greenhouse gas concentrations at a level which prevents dangerous interference with the climate system.</i> More details are available in the Article 10 of the EU Taxonomy Regulation⁸.
Climate change adaptation	<i>The activity :</i> - <i>Includes adaptation solutions that either:</i> - <i>Substantially reduces the risk of a negative impact of the current and future climate on the activity,</i> - <i>Substantially reduces negative impacts without increasing the risk of an adverse impact on other people, nature or assets; or,</i> - <i>Provides adaptation solutions that contribute substantially to prevent or to reduce the risk of the negative impact of the current climate and the expected future climate on people, nature or assets, without increasing the risk of an adverse impact on other people, nature or assets.</i> More details are available in the Article 11 of the EU Taxonomy Regulation.
The sustainable use and protection of water and marine resources	See Article 12 of the EU Taxonomy Regulation
The transition to a circular economy	See Article 13 of the EU Taxonomy Regulation
Pollution prevention and control	See Article 14 of the EU Taxonomy Regulation
Protection and restoration of biodiversity and ecosystems	See Article 15 of the EU Taxonomy Regulation

(2) Do not significantly harm the other objectives - DNSH

Do not significantly harm the other objectives is the second necessary condition. It ensures that the activity, by contributing to at least one environmental objective, does not impede the other ones. The purpose of the EU Taxonomy regulation is to define and further develop the criteria which justify how an activity does not negatively impact the other environmental objectives.

(3) Comply with Minimum Social Safeguards - MSS

The Minimum Social Safeguards are the procedures used by institutions to be aligned with the “*OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights*”. They must follow the principle of “do not significantly harm”.

(4) Meet the Technical Screening Criteria - TSC

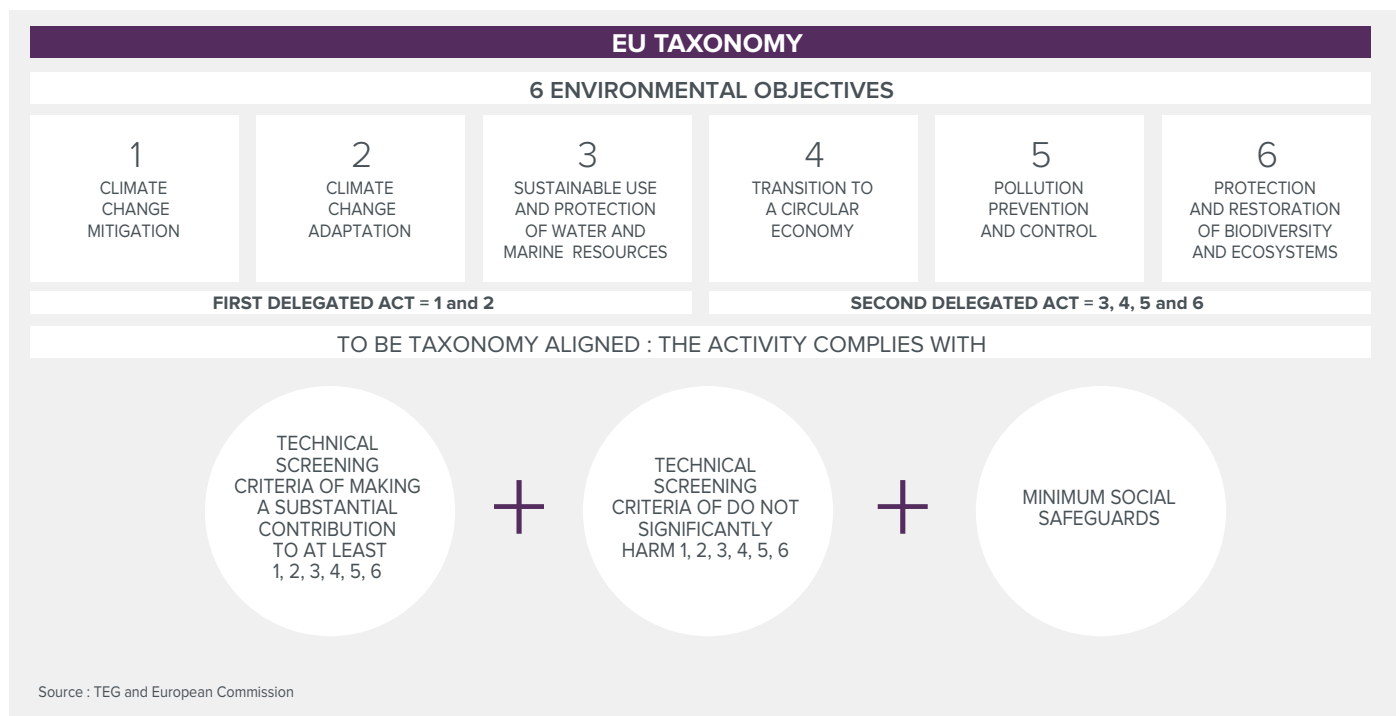
For each activity included in the 9 eligible macro-sectors, the EU commission has established a set of technical screening criteria, defining under what conditions an activity (1) makes a substantial contribution to one of the environmental objectives, (2) does no significant harm to the other objectives. The activity must comply with these technical screening criteria to be Taxonomy-aligned.

⁷ Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 (Text with EEA relevance). PE/20/2020/INIT. OJ L 198, 22.6.2020, p. 13–43.

⁸ Ibid.

The following figure summarises the concept of being EU Taxonomy-aligned :

FIGURE 1 : EU Taxonomy alignment.



As stated in the Article 8 of the EU Taxonomy regulation, Companies will need to publish the proportion of their activities which are aligned with the EU Taxonomy in their non-financial statement.

1.3 High level presentation of the scope and the implementation dates

The European Commission defines the activities aligned with the EU Taxonomy through Delegated Acts. A first delegated act was approved in April 2021 and discussed both the objectives of climate change mitigation and cli-

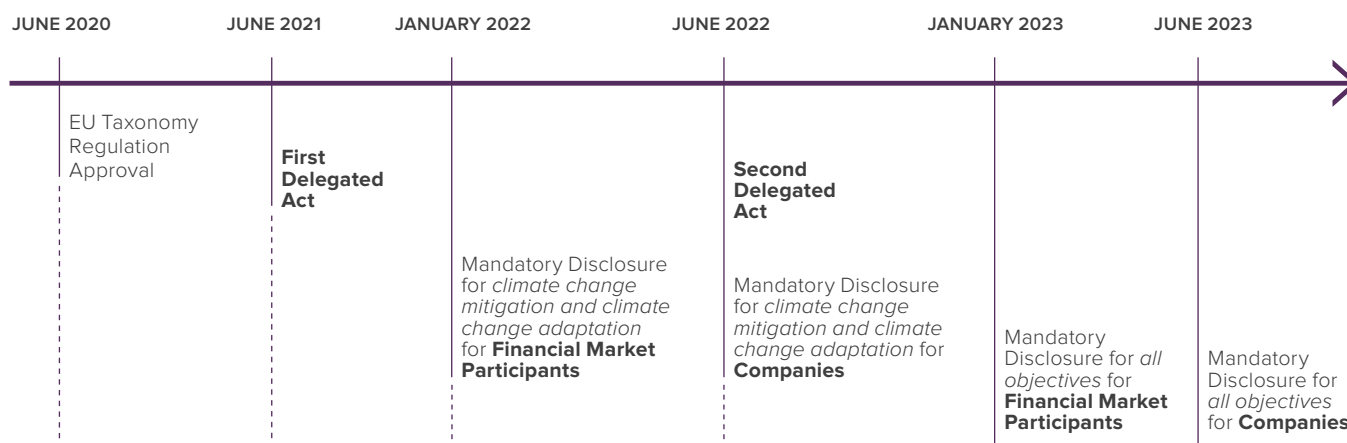
mate change adaptation. A second delegated act will be published in 2022, covering the other environmental objectives⁹. Financial markets participants will have to apply the first one by the 31st of December 2021 and the second by January 2023. The commission is well aware that having such a short period of time between the TSC approval and the entry into force of the regulation is a challenge but the implementation is still considered as feasible.

For companies under Art 19a or 29a of the Non-Financial Reporting Directive (NFRD)¹⁰, the Taxonomy will come into effect a bit slower: they will be required to disclose on the 2 first objectives from June 2022, followed by all the environmental objectives from January 2023. The following timeline provides more information on the EU Taxonomy regulation and Delegated Acts with their application:

⁹ Sustainable use and protection of water and marine resources; Transition to a circular economy; Pollution prevention and control; and, Protection and restoration of biodiversity and ecosystems.

¹⁰ see : Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups Text with EEA relevance. OJ L 330, 15.11.2014, p. 1–9.

FIGURE 2 : Timeline of the application of the EU Taxonomy Regulation and Delegated Acts.



Source : TEG (2020), P 26

The EU Taxonomy disclosures are mandatory for the following actors:

FIGURE 3 : Actors subject to the EU Taxonomy.



Source : TEG (2020)

The EU Taxonomy Regulation defines the classification system which, as explained above, aims to harmonise the sustainable information required within the different European directives/regulations. Hence, criteria and information as defined in the EU Taxonomy should be disclosed throughout the NFRD¹¹ = the Sustainable Finance Disclosure Reporting (SFDR)¹² and the Pillar 3 on ESG

disclosures¹³. Moreover, incoming regulations on sustainable finance may also require the information as defined within the EU Taxonomy Regulation, to pursue the harmonisation. This will imply that the principles stated in the EU Taxonomy regulation will be applied by the compliant companies in their prudential reporting process, but also in annual and periodic reporting.

¹¹ In April 2020, the European Commission published a proposal for a Corporate Sustainability Reporting Directive (CSRD), which should amend the NFRD. The proposal includes the extension for application, to all large companies and all companies listed on regulated markets. Whereas the NFRD applies to large companies that have more than 500 employees. *Questions and Answers: Corporate Sustainability Reporting Directive proposal*. (2021). European Commission - European Commission.

¹² "SFDR lays down harmonised rules for financial market participants and financial advisers on transparency with regard to the integration of sustainability risks and the consideration of adverse sustainability impacts in their processes and the provision of sustainability-related information with respect to financial products" Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (Text with EEA relevance). PE/87/2019/REV/1. OJ L 317, 9.12.2019, p. 1–16. It applies to financial market participants and applies from the 10th March 2021.

¹³ Avantage Reply published a paper on the Pillar 3 ESG disclosure available here : <https://www.reply.com/avantage-reply/Shared%20Documents/EBA-CP.pdf>

The European Commission mentioned that the EU Taxonomy can also be used on a voluntary basis by companies wishing to communicate on sustainability, for example to define environmental and sustainability transition strategies, to attract investors regarding green investments or in a due diligence process for investors to identify impact/sustainable investments opportunities.

1.4 Practical example for one activity defined in the EU Taxonomy : Electricity generation using solar photovoltaic technology

To have an overview of how institutions may inform on their taxonomy-aligned activities, this section will highlight one example of an activity discussed in the Annex 1 of the first Delegated act of the EU Taxonomy Regulation¹⁴.

The example chosen is part of the Energy sector and categorised as *Electricity generation using solar photovoltaic technology*. As defined by the EU Taxonomy, the activity analysed should substantially contribute to

climate change mitigation since it generates electricity using solar PV technology. This requires the identification of the technical screening criteria of substantial contribution to climate change mitigation.

For this category, the TEG has defined the following activity's description integrating NACE codes :

*"Construction or operation of electricity generation facilities that produce electricity using solar photovoltaic (PV) technology. Where an economic activity is an integral element of the 'Installation, maintenance and repair of renewable energy technologies' as referred to in Section 7.6 of this Annex, the technical screening criteria specified in Section 7.6 apply. The economic activities in this category could be associated with several NACE codes, in particular D35.11 and F42.22 in accordance with the statistical classification of economic activities established by Regulation (EC) No 1893/2006."*¹⁵

If the activity analysed is aligned with the above definition, it can be considered as an economic activity which significantly contributes to climate change mitigation. To be Taxonomy-aligned, the economic activity must also avoid significantly harming the other objectives. Hence, the following criteria established the conditions under which the activity analysed respects this principle:

TABLE 2 : Example of conditions for DNSH for activities aligned with "Electricity generation using solar photovoltaic technology"

ENVIRONMENTAL OBJECTIVES	DO NOT SIGNIFICANTLY HARM ¹⁶	GENERIC CRITERIA ¹⁷
(2) Climate change adaptation	<i>"The activity complies with the criteria set out in Appendix A"</i>	The Appendix A includes further criteria which must be analysed to assess the DNSH criteria for climate change adaptation
(3) Sustainable use and protection of water and marine resources	N/A	
(4) Transition to a circular economy	<i>"The activity assesses availability of and, where feasible, uses equipment and components of high durability and recyclability and that are easy to dismantle and refurbish."</i>	
(5) Pollution prevention and control	N/A	
(6) Protection and restoration of biodiversity and ecosystems	<i>"The activity complies with the criteria set out in Appendix D"</i>	The Appendix D includes further criteria which must be analysed to assess the DNSH criteria to protect and restore biodiversity and ecosystems

¹⁴ Annex to the Commission Delegated Regulation (EU) of 4 June 2021 supplementing Regulation (EU) 2020/852 of the European Parliament and of the Council. It establishes the technical screening criteria for determining the conditions under which an economic activity qualifies as contributing substantially to climate change mitigation or climate change adaptation and for determining whether that economic activity causes no significant harm to any of the other environmental objectives. Annex 1 Retrieved from https://eur-lex.europa.eu/resource.html?uri=cellar:d84ec73c-c773-11eb-a925-01aa75e-d71a1.0021.02/DOC_2&format=PDF

¹⁵ Ibid. page 73.

¹⁶ Ibid. pages 72-73.

¹⁷ Ibid. pages 189 and 194.

In order to help the stakeholders in the use of EU Taxonomy, the European Commission created the EU Taxonomy Compass which is an excel tool gathering the criteria per sectors of activity.¹⁸

Moreover, as defined in the article 20 of the EU Taxonomy Regulation, the European Commission will launch the **Platform on Sustainable Finance** which is a Tool for the European Commission to have a market view on how stakeholders are able to implement criteria established by the EU Taxonomy. Such a tool should enable the European Commission to monitor the implementation of the EU Taxonomy as well as to appropriately consider the update of specific criteria to fit the market. On the other hand, it should also enable stakeholders to make some specific requests to the European Commission on the EU Taxonomy implementation.

This section introduced an overview of the required criteria and definitions to be applied to respect the EU taxonomy.

It highlights the strict nature of those criteria, acting as “filters” which may prevent an activity from being EU Taxonomy aligned if one condition is not met. As a matter of fact, the EU Taxonomy implementation seems to be a real challenge for the financial sector which is supported by the fact that 90% of the global emissions comes from 25% of global companies. In addition, the TEG noticed that 93.5% of EU’s direct greenhouse gas emissions originate from only 7 NACE macro-sectors that are Energy, Transport, Buildings, Industry and Land Use related activities. The other 14 macro sectors include 64% of EU GDP, economic value added and jobs. This supports the fact that not all activities can be aligned with the EU Taxonomy since they are not included in the eligible sector as identified by the EU Taxonomy to make a substantial contribution to one of the environmental objectives.¹⁹

The following sections will explore the implementation of the EU Taxonomy into the governance, the data systems and the reporting of financial institutions.

¹⁸ This excel tool can be found through this : <https://ec.europa.eu/sustainable-finance-taxonomy/>.

¹⁹ Climate&Strategy & Climate Company. (2020). Page 5. “Applying the EU Taxonomy”: Lessons from the Front Line.

2. Setting up the right governance to implement the taxonomy

The Principles for Responsible Investment (“PRI”) established a report²⁰ covering case studies on the EU Taxonomy implementation of different stakeholders.

This report highlighted challenges faced by institutions, including the time investment to understand, apply and interpret the criteria. As stated in this report, they must be aware of the substantial work it involves and should consider solutions to comply with the EU Taxonomy regulation at an early stage. This section aims at giving a series of initiatives that can be taken to facilitate the integration of the regulation into the governance.

2.1 How to prioritise the implementation of the taxonomy

The relatively “new born” stage of the EU Taxonomy has been considered by some financial institutions as leaving some “room for interpretation”, meaning that a lot of its parameters are left to the decisions of the industry.

Thus, this implementation goes beyond the traditional evolution of the prudential and non-prudential regulation, and all business lines, from higher management positions to operations need to incorporate these requirements due to their transversal aspect.

As a consequence; the design of the process and the setting of priorities is a crucial step for the financial institutions in order to avoid any future gap.

The Principles for Responsible Investment paper advises the following in terms of prioritisation²¹:

²⁰ Principles for Responsible Investment. (2020). *Testing The Taxonomy Insights from The PRI Taxonomy Practitioners Group*. Page 16.

²¹ Principles for Responsible Investment. (2020). *Testing The Taxonomy Insights from The PRI Taxonomy Practitioners Group*.

- Start a complete ESG-data collection exercise from origination to monitoring (POC approach)
 - Due to the fact that the regulation has been published one year ago and that it covers really specific topics, the current stage of ESG regulatory requirements is far from the EU Taxonomy expectations, meaning that the workload is significant;
 - The expected ambitious development of the sustainability regulation could be an opportunity for banks to start their data collection process early in order to earn time and money in the coming years;
 - A “sampling” approach where an implementation of the EU Taxonomy is fully executed in one sector, industry or region could be an opportunity to understand challenges and plan full implementation more efficiently;
 - The current stage of ESG-data disclosure within the different sectors does not allow a top-down assessment, thus the bottom-up approach is recommended;
 - Quantification of KPIs is considered as best-practice;
 - Due to the significant proportion of stakeholders related-information to the EU Taxonomy, an early and dedicated strategy of stakeholders engagement is also pointed as a best-practice. It is not only virtuous for alignment with regulation, but also for relation and business continuity.
- Use solutions offering flexibility
 - Flexibility is to be considered as a middle-term risk management solution to avoid non-compliance;
 - This implies making internal analyses to highlight the most accessible and the most material information;
 - Flexibility is a key to manage expectations of all stakeholders due to regulatory evolutions and fine tuning are to be expected in the common years.
- Keep coherency with the overall regulatory strategy and roadmap of the institutions

- Maintain coherent deadlines with remaining prudential regulation, either common or alternative in order to maintain a smart management of the capacity;
- Such coherence could strengthen the position of the institutions in front of the supervisor and the shareholders.
- Allocate proper capacity to the EU Taxonomy implementation
 - Since several regulations, such as the NFRD/CSRD, the SFDR and the Pillar 3 ESG Risk Disclosures are aligned with the EU Taxonomy, it is this last regulation which implementation is to be prioritized. Early and ambitious process (i.e. implementation of overall EU ESG regulation rules) could allow institutions to face less stress in front of the supervisor;
 - Additionally it will allow the institutions to be more flexible regarding their implementation process;
 - Expertise is advised to focus in priority on the alignment towards DNSH, MSS criteria identifications as they are considered as more accessible and less complex to evaluate;
 - The arbitration from the beginning of the implementation between the internal capacity to allocate and the intervention of external specialists is judged as best-practice since appropriate expertise is quite uneasy to spot for financial institutions.
- Internally, it is necessary to involve and align as many parts of the organization as possible, so that they can collaborate. For example, the business will be in charge of engaging the clients but also of supporting the IT team in the adaptation of the internal systems and the process automation. Both will also work hand-in-hand to set up the data collection. In terms of engagement, it is also particularly crucial that the top management engages itself visibly in the implementation, alongside the back-office, middle-office and front-office;
- To make this broad involvement possible, trainings should be organised for the employees, covering EU Taxonomy-related questions and products;
- In parallel, the administration of the monitoring requirements will need to be integrated into the governance structure in order to clearly delimitate the roles of each internal function. Such a precise delineation allows to avoid the dilution of responsibilities and to hold people accountable for their actions;
- The legal practice has to be involved too as the legal documents should reflect the bank's new responsibilities towards its clients;
- Lastly, the environmental and/or social and industry sector specialists should play an important role of supervision: they must make sure that the banks' due diligence and monitoring processes are fully compliant with the EU Taxonomy.

2.2 How must the organisation adapt to overcome the challenges brought by the Taxonomy?

Obviously, the implementation of the Taxonomy comes with a series of challenges. The internal processes of information might become obsolete, the development of new IT tools can be costly and so far there is no common nomenclature for data collection and automation.

To overcome these new difficulties, the existing departments and procedures of the financial institutions need to be adapted in multiple ways²²:

2.3 External support and development of industry practices

In terms of governance, the contribution of internal actors at different levels and businesses of the bank can be encouraged (see section 3 Implementation into the reporting and business lines), but also the contribution of external stakeholders in order to proceed to the EU Taxonomy implementation:

²² European Technical Expert Group on Sustainable Finance. (2020). *Financing a Sustainable European Economy, Technical Report*.

- The contribution of clients²³

The contribution of clients is crucial as a proactive approach will allow banks to facilitate data collection. A substantial segment of the EU Taxonomy is indeed focused on counterparties themselves. The development of questionnaires and active communication with clients has been encouraged in order to structure and homogenise data collection.

The use of such tools eases the delivery of information by clients and the gathering and management of these data by financial institutions. Eventually, the use of surveys could be an opportunity for development of automated tools and databases.

- The contribution of investors and partners

The same goes with the other counterparties of a bank: involving its investors and partners will make data collection way easier, with better quality and potentially faster.

- The contribution of certification schemes²⁴

Added value could be created by the synergy between banks and existing (or newly created) labels and certification schemes.

Such certifications have some qualities that can be useful for the implementation of the Taxonomy:

- Historical and wide implementation across Europe and outside of the EU;
- Subscription from large companies to SMEs;
- Development of structured and public methodologies;
- Presence of verification and audit practices;
- Large presence of different certifications in the environmental and social topics.

Natural synergies can be underlined in the collaboration between certifications and banks, due to the amount, the level of comparability and the transparency of data that such certification schemes.

- The offer of independent experts and data providers²⁵;

Data providers have long practiced ESG data collection, with ambitious methodologies ensuring comparability within the different clients. Additionally, the wealth and asset management departments of banks have collaborated for the past decade with such services, which could create natural synergies and ease the integration of such services within the core banking reporting systems.

The presence of independent experts seems compulsory given the level of technicality of the reporting topic, different from expertise inside the bank. Moreover, such experts, as third-party verifiers, could be the de-facto responsible for some aspects of the EU Taxonomy compliance, not leaving this responsibility to banks.

2.4 An open door for industry collaboration

Collaboration between banks has been broadly practiced in the context of ambitious prudential regulation. The EU Taxonomy implementation makes this collaboration even more relevant due to the quantity of newly required reporting. Roundtables between financial institutions would be useful on the following topics:

- The methodologies used, since the banks have reported some challenges in terms of classification of clients with “mixed” activities (how can the level of “greenness” of a client be assessed), e.g.
 - A tool providing guidance to map NACE codification with existing classification standards;
 - Additionally, some collaboration regarding the development of common tools and questionnaires can be foreseen;
 - Finally, common assessment of thresholds and methodology of assessment against Substantial Contribution (i.e. carbon sequestration), DNSH and MSS criteria;
- Technological and data knowledge-sharing, since the development of common platforms and shared public data could contribute to an easier and homogenous data collection. The creation of a shared platform for specific data points could allow clients to provide only once a list of key indicators;

²³ European Banking Federation & UNEP Finance Initiative. (2021). *Testing the application of the EU Taxonomy to core banking products: High level recommendations*

²⁴ European Banking Federation & UNEP Finance Initiative. (2021). *Testing the application of the EU Taxonomy to core banking products: High level recommendations*.

²⁵ European Banking Federation & UNEP Finance Initiative. (2021). *Testing the application of the EU Taxonomy to core banking products: High level recommendations*

3. The impact on data management

3.1 Challenges in terms of data

One of the main challenges spotted by the financial sector is data. The completeness of the Taxonomy includes that in the coming years all the 6 objectives of the Taxonomy will be subject to reporting and that all types of counterparties and activities can be selected by the institutions as Taxonomy-compliant.

This implies that the required data is sourced and used for the Taxonomy reporting for different types of companies. Some of them are already bound to disclose the targeted data, i.e. listed and large companies located in the European Union. On the other hand, it is anticipated that such data gathering will be less accessible for retail clients, smaller companies and companies not located in the European Union.

For such counterparties, the following issues are key²⁶:

- Limited data availability (no reporting, uneven reporting);
- Poor quality (non-availability of annual reports);
- Mismatch with Taxonomy requirements or irrelevance of reported data (i.e. disclosure of gross revenue or limited balance sheet only);
- Low data granularity (no breakdown per activity);
- Low data comparability and standardization (unstandardized annual reporting with zones outside Europe, data spread across the report);
- Low quality of disclosure (no dematerialized report, scanned report).

This is especially the case for the criteria of DNSH and MSS for which available data on the market is clearly insufficient in terms of availability and granularity.

This observation creates an unclarity in the data collection and aggregation process, that could cause a non-efficient sourcing process, a reduced possibility of automation, a low standardisation across the industry and a high complexity of process.

The previous section of this report was focused on the governance aspects of reporting in a top-down approach. Providing concrete pieces of advice in terms of data management to prepare financial institutions for their Taxonomy reporting is the target of this new section.

3.2 What data is required to fulfill the requirements?

For each relevant product, financial market participants will be required to disclose:

- How and to what extent they have used the EU Taxonomy in determining the sustainability of the underlying investments;
- To what environmental objective(s) the investments contribute; and
- The proportion of underlying investments that are EU Taxonomy-aligned, expressed as a percentage of the investment, fund or portfolio. This disclosure should make the distinction between enabling and transition activities²⁷, as defined under the EU Taxonomy Regulation.

In order to assess which percentage of their fund is invested in EU Taxonomy aligned activities, investors can base their analysis on 3 main financial metrics:

- Turnover: the overall turnover of a firm is its total revenues over some period of time. In the context of the Taxonomy,

²⁶ Principles for Responsible Investment. (2020). *Testing The Taxonomy Insights from The PRI Taxonomy Practitioners Group*.

²⁷ Transition activities are activities for which it is not possible yet to be carbon-neutral but that have significantly lower Greenhouse Gas emissions than their industry average and avoid lock-in to carbon-intensive assets of processes. On the other hand, enabling activities enable low-carbon performance or substantial emissions reductions in another sector.



it gives a clear idea of where a company stands relative to the regulation, and can be used as a proxy for equity exposure to EU Taxonomy-aligned activities.

- **Capex:** A capital expenditure (capex) is a payment for goods or services recorded, or capitalised, on the balance sheet instead of expensed on the income statement²⁸. In the context of the EU Taxonomy, it is a key variable to assess the credibility of a company's strategy. It helps investors to evaluate whether they agree with this strategy and whether they can include this investment in a green portfolio.
- **Opex:** Operating expenses (opex) are shorter-term expenses required to meet the ongoing operational costs of running a business²⁹.

3.3 What data is already available within the bank?

As mentioned above, a first step for the banks to evaluate their implementation process is to realise a gap analysis between the above-mentioned financial data they already have, and what is still missing. A further step could be to evaluate the possibilities to capture data available in the market that they do not have sourced so far.

A hypothesis can be made that access to Turnover, Opex and/or Capex and split between activities is easier for EU-based companies, listed companies and large companies binded by the NFRD.

Some banks also have made the decision to prioritize the scope of their counterparties already subject to the prudential regulation as access to their financial indicators is more familiar to the teams in charge of reporting.

²⁸ European Technical Expert Group on Sustainable Finance. (2020). *Financing a Sustainable European Economy, Technical Report*.

²⁹ *ibid*

It has been advised from several sources to create mapping tables between existing classification schemes (climate tracking methodology) and the Taxonomy in order to simplify the aggregation process and the gap analysis of the financial institutions.

Climate & Strategy Partners and Climate Company propose as an example a mapping table between specific technical screening criteria of the Taxonomy and the Rio Markers Initiative³⁰:

TABLE 3 : Example of a mapping table between specific technical screening criteria of the Taxonomy and the Rio Markers Initiative.

#	Activity	Evaluation	Rio Markers	Taxonomy		
			Climate coefficient of the Rio Markers	Covered by the Taxonomy	Potential Economic Activity	Description Screening Criteria
	Digitising SMEs (including e-Commerce, e-Business and networked business processes, digital innovation hubs, living labs, web entrepreneurs and ICT start-ups, B2B)	Use Taxonomy	0%	Partially Covered	Enabling GHG emission reductions (71), Compliance with the “European Code of Conduct for Data Centre Energy Efficiency	-71: No threshold if activity processes or collects data for the first objective; -72: Data Centre must comply with the second.
	Energy efficiency and demonstration projects in SMEs and supporting measures	Use Taxonomy	100%	Partially Covered	Construction of new buildings (57), building renovation (58), individual renovation measures (59), and acquisition of buildings (60).	-57: Net Primary Energy Demand (PED) must be >20% lower than the NZEB requirement (nearly zero-energy building, national directives); -58: Reduction of PED by >30% OR renovation compliant with “major renovation” transposing the EPBD; -59: Long list of individual measures with and without requirements; -60: Buildings built before 2021 must be within the top 15% of the local building stock in terms of PED, Buildings built after must comply with requirements from EPBD
	Household waste management: prevention, minimisation, sorting, recycling measures	Use Taxonomy	0%	Partially Covered	Separate collection (48), Composting of bio-waste (50):	-(48): no threshold applies if “source segregated waste is separately collected with the aim of preparing for reuse and/or recycling”; -(50): no threshold applies if bio-waste is collected separately, anaerobic digestion is not a viable alternative, and compost is used as fertiliser

³⁰ Climate&Strategy & Climate Company. (2020). “Applying the EU Taxonomy”: Lessons from the Front Line.

It can be noted that such a table already proves a high level of understanding of the requirements of the Taxonomy. Even more high level tables linking existing sector classification schemes (at the company level and not the activity level) and the NACE codes could be considered as a starting point.

The above table is interesting as it again demonstrates the level of flexibility allowed by the Taxonomy regulation at the current stage (even partial alignment with Taxonomy requirement is acceptable).

In addition, it is also acceptable to use assumptions. For example, the organizations are allowed to presume compliance of EU based companies and assets with applicable EU legislation unless evidence to the contrary (i.e. non-compliance with applicable environmental and social regulations) is readily available to banks and until the NFRD enforces relevant disclosures effectively.

3.4 Where to find the required data?

The EBF and the UNEP FI wrote a paper³¹ on the application of the EU Taxonomy within the banking sector, highlighting the big challenges faced by the banks, although this may be true for other institutions. Information and data required in the establishment of the EU Taxonomy should come from the client themselves. Therefore, banks will need to request more information from their clients to be compliant, implying a necessity to further ease the access to the required data.

This analysis highlights that currently, information gathered by banks is too limited to be relevant for the EU Taxonomy implementation. However, it is also mentioned that the future new NFRD enforcements, implying an alignment to the EU Taxonomy, will facilitate access to required client information.

³¹ European Banking Federation & UNEP Finance Initiative. (2021, January). *Testing the application of the EU Taxonomy to core banking products: High level recommendations*. Page 57.

4. Implementation into the reporting and impact on business lines

4.1 Coherency with current ESG reporting requirements

Establishing a common classification of sustainable activities in the EU was just the first step of the European Commission Action Plan for Financing Sustainable Growth, many others will follow in the next months and years. The EU Taxonomy is also part of a broader framework of reporting on sustainability, as it can be noted from the following chart. It can be seen as the reference classification to be used when applying the other regulations.

The European Commission established this Sustainable Finance framework to create a comprehensive reporting environment with different disclosure requirements, including the new EU Taxonomy. The current NFRD is reviewed in order to extend its application to a larger number of companies (CSRD).

For companies falling under the NFRD, in addition to using the EU Taxonomy, it will be easier to disclose the environmental performance information. Furthermore, the SFDR requirements also include the same definitions as stated in the EU Taxonomy such as “environmentally sustainable economic activities” and “sustainable investments”. It can also be mentioned that consultation from the EBA on the draft technical standards on Pillar 3 disclosures of ESG risks was also established in parallel with the advice from the European Commission on the EU Taxonomy requirements.

Since these prudential and non-prudential regulations have common elements in terms of structure (ex: use of the NACE classification) and content (ex: focus on the carbon intensity of counterparties, on GHG emissions, etc.), they can be seen as complementary. Therefore, it makes sense to implement them all together and to use the EU Taxonomy to integrate the other regulations. On top of the savings in terms of time and resources, it helps the company to give a comprehensive view of its sustainable activities.

FIGURE 4 : Integration of the EU Taxonomy in regulations related to ESG criteria.

EU TAXONOMY : CLASSIFICATION SYSTEM

SFDR

Article 5, 6 and 7 of EU Taxonomy Regulation, established information to be disclosed for **Financial Market Participants**:

- Transparency of environmentally sustainable investments;
 - Transparency of environmentally sustainable investments; and
 - other financial products;
- in pre-contractual disclosures and in periodic reports.

NFRD/CSRD

Article 8 of EU Taxonomy Regulation mentioned that **large institutions** shall include in their non-financial statement or consolidated non-financial statement information on how and to what extent the undertaking's activities are associated with economic activities that qualify as environmentally sustainable as stated in EU Taxonomy Regulation

PILLAR 3

Pillar 3 is a prudential regulation framed into the overall existing perimeter.
Disclosure requirements on Green Asset Ratio on Taxonomy-aligned activities for **financial Institutions**.

4.2 Taxonomy reporting in practice

Concretely, assessing the sustainability of an investment or a counterparty can be done through a five steps process, proposed by the TEG in its final report on Sustainable Finance³².

- 1) Identify which activities conducted by the company or covered by the financial product could be aligned with the Taxonomy and for which of the 6 objectives. The eligible activities are the ones that fit one of the NACE macro-sector categories identified by the TEG³³.
- 2) For each potentially aligned activity, check if the company or the issuer meets the relevant screening criteria (for instance for electricity generation, less than 100 g CO₂e/kWh);
- 3) Check that the DNSH criteria is respected by the counterparty or the issuer;
- 4) Proceed with a due diligence process to make sure the social minimum safeguards³⁴ are not violated;
- 5) Calculate the alignment of the investment with the EU Taxonomy, and prepare the appropriate disclosure.

For this calculation, the regulators have not yet designed a precise methodology but some high level guidelines have been defined for the two first objectives, climate change mitigation and climate change adaptation.

It is important to note that the three financial metrics stated in previous sections (Turnover, Capex and Opex) cannot be used in the same way for all the objectives nor for all the activities. The turnover in particular is taken into account differently whether we consider transition activities or enabling activities. In its final report of March 2020, the Technical Expert Group has summarised the way to treat each kind of substantial contribution in two decision trees which can be found in the Appendix, annex 1.

Additionally, the TEG published a decision tree to support companies in their assessment for the assessment of the Do Not Significant Harm criteria. Following the TEG report, *“The scope of activities taken into consideration for DNSH*

mirrors the mitigation scope of activities. However, for a small number of activities two or three differing sets of DNSH criteria were deemed necessary. As an example, within the manufacturing macro-sector, NACE code 20.13: Manufacture of other inorganic basic chemicals, there is one set of mitigation criteria and three sets of DNSH criteria divided into soda ash, carbon black and chlorine”. The decision tree can be found in appendix - Annex 2 of this report.

In parallel with the quantitative analysis (the percentage of aligned activities), some narrative disclosures can be added to give more details on a strategy, in particular when the percentage is low. For example, if a product targets companies with a low ESG performance but improving over time, the narrative disclosures can further explain this approach and expose the methods used to engage companies to do better.

4.3 Impact analysis of the Taxonomy alignment on selected banking processes

RETAIL LENDING³⁵:

Why is it impacted? General purpose Retail loans and Revolving Credit Facilities represent a significant proportion of banking transactions in terms of volume and banks' balance sheets. Currently, the disclosure of the use of the proceeds of such financial products is not homogeneous across the industry. Yet, the use and accounting destination made of this proceed has an influence on the alignment or not with the EU Taxonomy.

The European Banking Federation and the UNEP Finance Initiative give the example of a loan contracted by a large financial corporation. The bank is not always able to have a view on the final destination of this loan, whether it is going to be split or not over several infrastructures, or whether it is going to be deposited to a subsidiary for a specific project, within or outside the EU. This is even more challenging if a client is operating within several sectors of activity.

³² European Technical Expert Group on Sustainable Finance. (2020). *Financing a Sustainable European Economy, Technical Report*.

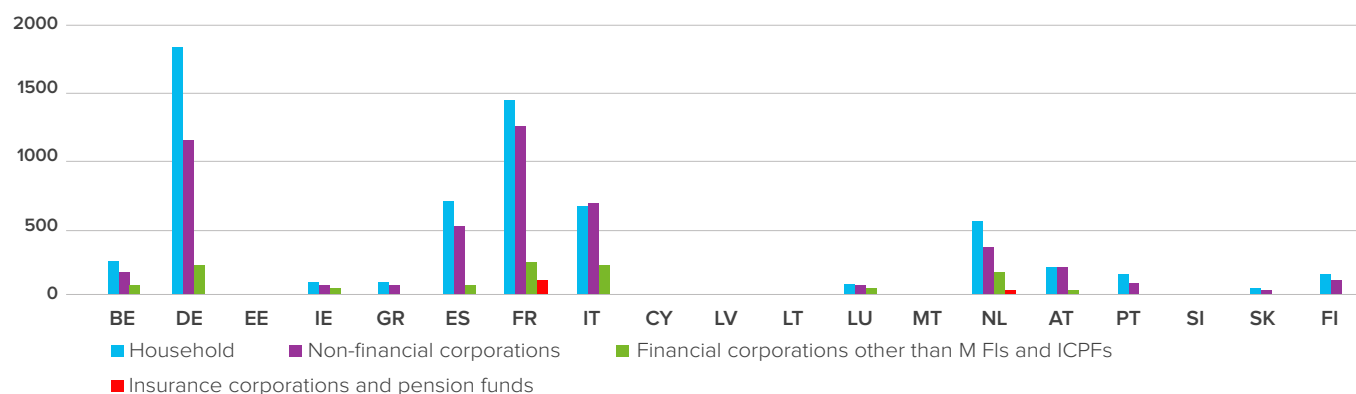
³³ The TEG defined a list of 70 climate change mitigation and 68 climate change adaptation activities.

³⁴ Article 13 of the EU Taxonomy Regulation

³⁵ European Banking Federation & UNEP Finance Initiative. (2021, January). *Testing the application of the EU Taxonomy to core banking products: High level recommendations*.

FIGURE 5 : Graph representation of sectoral breakdown of MFI loans vis-a-vis other euro area residents: December 2020.

Sectoral breakdown of MFI loans vis-a-vis other euro area residents: December 2020 (EUR billions)



- **Specification of the use of proceeds:** due to the impact of loans in terms of volume, the development of specification of such proceeds can be encouraged:

- Qualification of the loan: encourage the description of the loan use by the client i.e. general or specific purpose, specific project;
- Specify the alignment of specific loans with the EU Taxonomy objectives (i.e. contribution towards mitigation AND/OR adaptation or contribution through own performance);
- Encourage discussion and communication of data from clients;
- Populate sources of evidence and materiality in respect with the Substantial Contribution, Do Not Significantly Harm and Minimum Social Safeguard criteria;

- **Use of incentives and assumptions:** in case of inability to define the use of proceeds, banks are welcome to use assumptions to classify their exposures i.e. the use of a single set of financial indicators to define the proportion of involvement of the company in several sectors of activity, in other situations; the use of the business activity of the client could replace the use of proceeds to classify alignment with the EU Taxonomy.

SME LENDING:

Why is it impacted? In terms of individual number of clients and total volume, the households and the non-financial corporations represent the high majority of lending clients for EU banks. This implies that the necessity of gathering the necessary data points for a significant number of counterparties, without comparison to financial institutions for which the required data is far more accessible.

- **Use of assumptions:** the different stakeholders of the EU Taxonomy, are advised to let banks use assumptions regarding the level of Taxonomy-aligned activities of their counterparties³⁶, even in case of low quality and granularity of data, in the context of the ongoing implementation of ESG Regulatory reporting for banks, financial market participants and overall companies across the EU.

- **Alternative methodologies in case of limited data³⁷:**

- Banks are encouraged to use several alternative methodologies in case of limited data available for SMEs: i.e. development of statistical measures on a sector basis in alignment with the industry;
- Use of external proxies and certification schemes to “fill the gaps”.

RISK DEPARTMENT – MODELLING

Why is it impacted? The overall banking products, from mortgages to corporate lending, are based on scenario analysis and modelling. Environmental reporting and risk management is relatively new to banks, meaning that the industry is in need of the development of expertise, tools and methodology in this department. It is even more necessary due to the fact that ESG risk management is based on a mix of financial and non-financial indicators and it is characterised by uncertainty and multiple timing horizon.

³⁶ European Banking Federation & UNEP Finance Initiative. (2021). *Testing the application of the EU Taxonomy to core banking products: High level recommendation*

³⁷ European Banking Federation & UNEP Finance Initiative. (2021). *Testing the application of the EU Taxonomy to core banking products: High level recommendations*.

Expert groups, researchers and institutions have been developing methodologies for the past years, before the start of the EU regulation, creating opportunities for financial institutions. The following advice can therefore be noted:

- Familiarisation of the current teams and investment in climate scenario expertise. This is coming through the training from higher management to day-to-day and front offices to such principles;
- To this goal, several pilot climate stress tests and sensitivity analyses are available (e.g. ECB, ACPR, EBA) since supervisors already used such scenarios analyses to evaluate the ability of the banking sector to adapt to adverse market developments;
- The Network for Greening the Financial System (NGFS) has been one of the leaders providing tooling for the risk departments of the industry – and beyond – developing a set of eight scenarios evaluating the evolution of climate policies. These scenarios used diverse assumptions related to technological development, socio-economic context in diverse parts of the world, level of greenhouse gas emissions and consumer preferences.
- Methodologies and human resources capacity are now available for banks to incorporate climate scenario analysis, reducing uncertainty and bringing to the core business of financial institutions confidence when implementing these principles.

4.4 Impact on selected financial products (loans, financial products coming from securitisation)

Financial products marketed into or manufactured in the European Union, including pension products, will be required to refer to the Taxonomy. Products in scope are summarised in Table 6. Financial market participants may choose to use the Taxonomy for other product types if they wish. Individual financial instruments – e.g., bonds – are not directly included in the Taxonomy disclosure obligation.

FIGURE 6 : List of financial products in the scope of the EU Taxonomy

MARKET SEGMENT	IN SCOPE FOR TAXONOMY DISCLOSURE
Pensions and Asset Management	• UCITS funds: • equity funds • exchange-traded funds (ETFs) • bond funds • Alternative Investment Funds (AIFs): • fund of funds • real estate funds • private equity or SME loan funds • venture capital funds • infrastructure funds • Portfolio management (under Article 4(1) of MiFID II) • Pensions: • pension products • pension schemes (defined with reference to IORP II) • pan-European personal pension products
Insurance	• Insurance-based Investment products (IBIPs)
Corporate & Investment Banking	• Securitisation funds • Venture capital and private equity funds • Portfolio management • Index funds

Source : TEG (2020)

The nature of the required disclosure differs depending on the type of fund, as defined in the Regulation on Sustainable Finance Disclosure Regulation (SFDR).

FIGURE 7 : Financial products mentioned by SFDR to be aligned with the EU Taxonomy

ARTICLE SDR	DESCRIPTION	OBLIGATION
Article 9	Financial products which have sustainable investment ⁴¹ as their objective.	Must complete Taxonomy disclosures where the investment concerns activities that contribute to an environmental objective.
Article 8	Financial products which promote environmental or social characteristics of the investment, either alone or in combination with other characteristics.	Must complete Taxonomy disclosures where environmental characteristics are promoted.
Article 7	All other financial products.	Must complete Taxonomy disclosures or carry a disclaimer that “the investment(s) underlying this financial product do not take into account the EU criteria for environmentally sustainable investments”.

Source : TEG (2020)

5. Conclusions

The implementation of the Taxonomy for Sustainable Activities can be a challenge for banks due to the fact that this regulation remains under discussion for its granular specificities. Several delegated acts have been published over the last months in order to provide more precise instructions to the industry - and future publications are still planned. The banking industry and the literature only begin to develop interpretations and keys for implementation, leaving the financial institutions with a large room for interpretation.

This paper is an opportunity to detail the meaning and the goal of the 6 different objectives and the technical screening criteria of the regulation, which are an outstanding feature of this reporting rule. They create a complex set of rules and concepts that implies a solid understanding of its principles for the financial institutions to be compliant.

This paper shows that the Taxonomy for Sustainable Activities is a challenge in terms of classification and transparency, but also in terms of content. The set of criteria are acting as strict filters and it is necessary for financial institutions to acquire expertise in environmental topics. Such expertise is quite distant from traditional reporting topics, it consists of other challenges such as energy, carbon emissions, fossil fuels...

Meanwhile, the EU Taxonomy is going to be considered as a cornerstone of the ESG reporting as it is not a reporting

requirement in itself. It is more of a format of reporting to be followed to be compliant with the CSRD/NFRD, applicable to all large companies, the SFDR, applicable to all financial market participants, and the Pillar 3 disclosures requirements, applicable to all financial institutions subject to the prudential regulations. It is to be noted that the plan of the EU is to propose the EU Taxonomy as a common standard over the different sectors of activity, not only the financial sector.

If a financial institution is compliant with the EU Taxonomy, it does not tick a box in its reporting requirement agenda, however it moves a step forward in a list of several of its commitments.

The complexity of this regulation, its nascent stage of development, and its high level of expectations, can also be taken as an opportunity for financial institutions to mutualise their needs of data. The EU Taxonomy shall be considered as a common language for all the sectors of activities. The development of common tools and best practices could help institutions to reduce scope and uncertainties in their implementation process, which Avantage Reply is advising.

Our goal in this paper was to bring to the financial sectors a complete understanding of the key principles of the EU Taxonomy, its objectives and technical criteria; and to provide concrete keys for a voluntary strategy of implementation in all the departments of the financial institutions.

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7. Appendix

ANNEX 1

Decision trees for substantial contribution to climate change adaptation and climate change mitigation - TEG, March 2020, page 16 and 22:

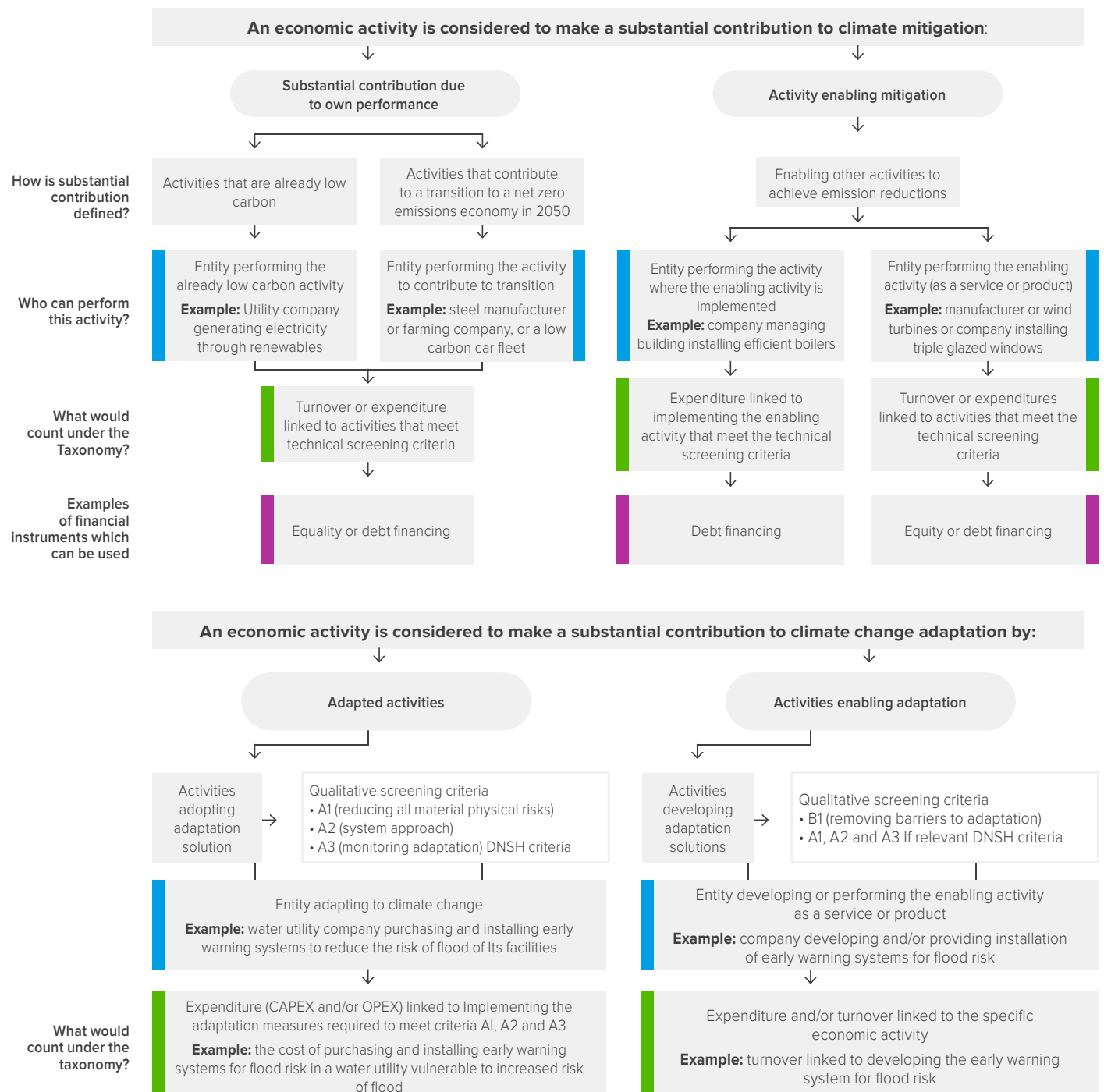
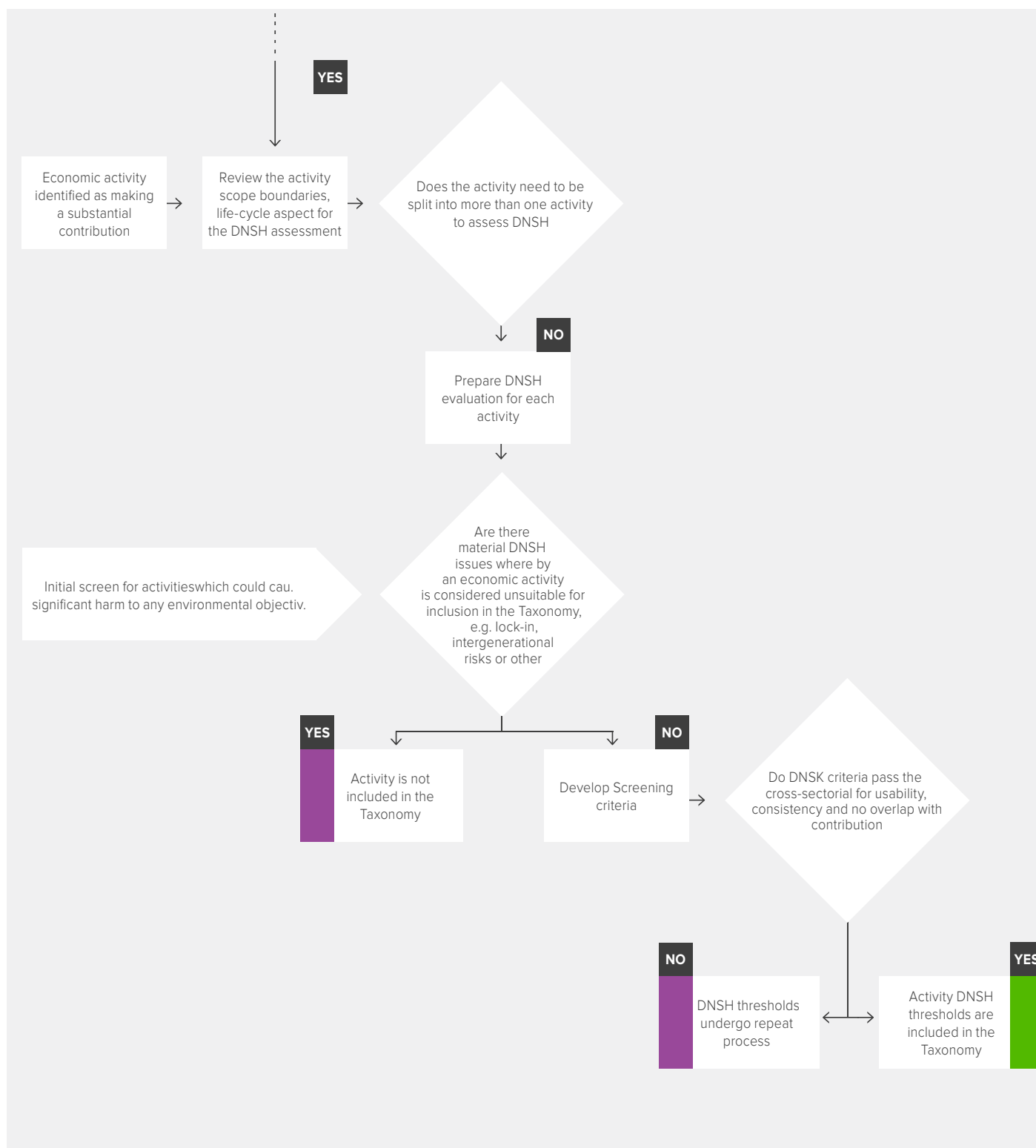


FIGURE 3 Decision tree for substantial contribution to climate change adaptation

ANNEX 2 Decision tree to support companies in their assessment of the Do Not Significant Harm criteria, TEG, March 2020 p.35:



Thank you !

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