Reg News

# EU Taxonomy

## Regional ESG Initiative. Global Impact. Looming Deadline.

**As the world grapples with the climate crisis, food scarcity, ocean acidification, among a host of abuses against the planet, corporations have moved from simply reacting to more proactively courting the public's approval.**

This shift has led many market participants to explore their own initiatives to promote long-term sustainability while achieving economic growth. For example, the Financial Stability Board (FSB) created its own Task Force on Climate-Related Financial Disclosures (TCFD) to help participants standardize the information required to report their commitment in addressing corporate climate-risk management.

### A patchwork of initiatives.

Such initiatives have resulted in a patchwork of constantly evolving environmental, social, and governance (ESG) rules, locally and globally. However, if investors suspect greenwashing or find it onerous to check and compare different financial products – across national classifications and labeling schemes, for example – they are less inclined to invest in environmentally sustainable financial products. Without investor confidence, at a minimum, the market is starved of investments.

### Emerging clarity.

Today, regulators worldwide have added clarity by adopting and incorporating ESG regulations that homogenize assessment methods and disclosure requirements. One such framework is *Regulation (EU) 2020/852 of the European Parliament and of the Council* (EU Taxonomy).

**EU Taxonomy provides investors, companies, and policymakers with definitions as to which economic activities are considered environmentally sustainable, thereby encouraging more climate-positive investment activities.**

While the EU has been leading on ESG initiatives, the impact of climate change does not recognize borders, and so climate-risk assessment is becoming increasingly vital. Other global regulatory developments include:

- **Brazil** Social, Environmental and Climate Risk Document / Documentos de Risco Social, Ambiental e Climático (DRSAC)
- **Colombia** Green Taxonomy / Taxonomia Verde de Colombia
- **Singapore** Disclosure of Retail ESG Funds and Singapore Green Taxonomy
- **US** SEC-proposed ESG Fund Disclosure, FRB-proposed draft Principles for Climate-Related (ESG) Financial Risk Management for Large Financial Institutions
- **UK** Sustainability Disclosure Requirements (SDR) and Investment Labels, and UK Green Taxonomy

## Looming deadline

For credit institutions, asset managers, investment firms, and insurance companies, who must already disclose their eligible activities, the deadline for this challenging taxonomy alignment is January 1, 2024. Now only a year away, there is little time to determine how to categorize investments as environmentally sustainable, i.e., in accordance with the regulation's environmental objectives and alignment with the EU taxonomy classification (https://ec.europa.eu/sustainable-finance-taxonomy/taxonomy-compass). And this would just be step one on the compliance journey.

# What constitutes sustainable finance/investment?

In response to the UN's 2030 Agenda environmental goals, the EU established its own green deal to reduce greenhouse gas (GHG) emissions by at least 55% by 2030 and achieve net-zero emissions by 2050. As part of the EU Green Deal, the European Commission formulated regulations focused on sustainable finance, activities supporting the transition to a climate-neutral economy. Examples of these regulations include ESG Pillar 3 (EBA), Sustainable Finance Disclosure Regulation (SFDR), Corporate Sustainability Reporting Directive (CSRD). The bedrock of all these evolving regulations is the EU Taxonomy.

The EU Taxonomy is a classification system of environmentally sustainable economic activities for market participants. It also establishes procedures for calculating the taxonomy-alignment ratio known as the green asset ratio (GAR) towards six environmental objectives:



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 (maximize product use while minimizing waste through recycling/restoration)**
5. **Pollution prevention and control**
6. **The protection and restoration of biodiversity and ecosystems**

For investments to be considered sustainable, they must pass eligibility and alignment tests detailed in the EU Taxonomy Compass as follows.

- An investment is considered eligible if it is geared towards economic activities that qualify as environmentally sustainable. It is then assessed to establish the degree to which it is environmentally sustainable.
- An activity is considered aligned if it is performed in a way that substantially contributes to one of the six objectives, does not significantly harm any of the other five objectives, and meets minimum safeguards.

Financial activities are assessed against the underlying criteria and key performance indicators of these economic activities to calculate the proportion of an institution's total assets considered to be environmentally sustainable.

## What's the impact of the EU Taxonomy on market participants?

For **investors** involved in building and maintaining green portfolios, the EU Taxonomy provides clarity for identifying investments that best meet the six environmental objectives. Furthermore, the use of common criteria for disclosures helps investors compare investment opportunities across borders, which in turn reduces the risk of greenwashing, enhances market efficiency, and directs investments to more sustainable activities.

For **companies**, the EU Taxonomy acts as a roadmap for attracting funding. It provides tools for more sustainable operation and enables institutions to reinforce and substantiate their sustainability objectives to potential investors eager for such investments. It also provides the key to preventing reputational damage by operating in more climate-friendly activities.

The repercussions of a low GAR go beyond reputational damage and may even be reflected in higher costs of borrowing. For example, if a mortgage is given for a house that is not sustainably built (e.g., the Energy Performance Certificate (EPC) rating is poor or the energy usage metrics are too high), the lender's GAR ratio could be negatively impacted. The bank, in turn, could preempt this impact by increasing the mortgage rate.

NB: Albeit theoretical, this represents potential evolutionary movement for stakeholders to align with the EU Green Deal objectives.

The taxonomy also impacts **financial institutions** on an operational level, both functionally and technically. The regulation introduces new criteria against which counterparties and investments are assessed, which deviates from purely financial and traditional metrics. Furthermore, the methodology used to identify environmentally sustainable investments differs depending on the sector and geography of the counterparty.

- **Functional implications cover more than just new templates.** Non-financial information is now required to be used as part of the calculations to determine the alignment of an economic activity. Examples include tailpipe emissions of a vehicle used as collateral for a loan, the EPC rating of a house used for a mortgage, or GHG emissions for a company.

  NB: Non-financial information is required to be disclosed for Pillar 3 and SFDR, as well as for EU Taxonomy calculations themselves.

  To further complicate matters, for mandatory reporting requirements, regulators only accept reported data, i.e., data disclosed directly from the counterparties – either by the institution themselves or through market data providers – so data providers may not have access to the required data. For example, if an institution invests in private companies under the Non-Financial Reporting Directive (NFRD) market data providers would not have access to this data. The institution would need to source the information directly.

  Because this taxonomy forms the basis for other EU ESG regulations, in that the reported results (GAR) are required to be disclosed, it is important that the infrastructure scales to cover these and other global regulations.

- **Technical challenges are primarily around data.** Here, the main challenge is the need for more granular counterparty data sources. The many data-intensive calculations require an increasingly granular data set, which is driven by the type of counterparty and their related sectors. But there are carryon effects. Once the data is sourced, it must be effectively and logically implemented into a solution. The good news is that this data can then be leveraged across multiple regulatory requirements. The dilemma arises when both the large amount of counterparty-data implementation and the data-intensive calculations demand a high-performance and modular solution.

  A second challenge is linked to data collection. As mentioned earlier, market data providers generally only have data for public companies, which cannot be used for investments in private companies. Therefore, institutions need to develop additional processes to collect this information. The same goes for household information, such as that for mortgages and car loans.

## What's next?

**On the EU regulatory front**, several developments are expected. First, as regulators have only outlined definitions for the first two environmental objectives – climate change mitigation and adaptation – clarification on the four remaining objectives is certain. Second, with the recent inclusion of nuclear and gas to the list of economic activities, further amendments may well be on the horizon as the policies evolve. Third, although the focus has primarily been on climate taxonomy, the European Commission is in the process of building its social taxonomy, which touches upon corporate social factors including gender equality and humane supply chains. This yet-to-be-published regulation will certainly come with its own eligibility attributes and nuances.

That is not to say that the attention remains on the EU Taxonomy. With the spotlight on climate-risk management, a host of other existing or in-progress regulations also need consideration. For example, Pillar 3 is instrumental in assessing the physical and transition risks of counterparties and their transmission channels towards the conventional financial risks (credit, market, and operational risks). Climate scenario testing is also an increasingly hot topic, with the ECB having conducted its own climate stress testing on EU banks and the growing impact of climate-related risks on capital requirements for banks.

And this only covers the EU developments! **Elsewhere**, other global regulations are quickly catching up with the EU, which means that disclosure obligations for financial institutions are only going to increase.

**Given all the regulatory activities, having an infrastructure in place that addresses both the technical and functional challenges resulting from the EU Taxonomy requirement, and scales for other regulations, is critical.**

This infrastructure must enable institutions to identify reliable market data sources that provide both non-financial information for use across regulations and address the volume of granular-counterparty data needed for calculation and reporting considerations.

While regulators understand that reported KPIs and metrics (including GARs) may well be low or non-existent in the short term, due to a lack of data and the difference in the type of information required, financial institutions must now establish end-to-end, transparent execution of ESG-related calculations, report allocation, and report generations.

**Investments and reputations are at stake.**

**While the EU leads the way on ESG initiatives, the impact of climate change does not recognize borders. Other global regulatory developments are underway in Brazil, Colombia, Singapore, the UK, and the US.**

**Contact Adenza** about how we can help you to meet your compliance requirements.



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