The EU Taxonomy

An Operational Minefield for Credit Institutions

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

And while the EU Taxonomy covers a range of institutions that operate under the Non-Financial Reporting Directive (NFRD) – including asset managers, investment firms, and insurance companies – credit institutions are particularly under the gun because of their critical role in financing green activities. In fact, they are currently contending with the requirement to publish the amount and proportion of a bank's taxonomy-eligible assets, as discussed previously in *EU Taxonomy: A regional ESG initiative with a global impact. – Adenza.*

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At the same time, they must address the particularly strict obligation of calculating and disclosing the alignment of banking book and off-balance sheet assets requirements with deadlines in January 2024 and January 2026, respectively, as discussed previously in *Getting ahead of an avalanche of ESG regulatory requirements. – Adenza.* This includes publishing green asset ratios (GAR) by environmental objective, client category, and exposure type.

Though groundbreaking in its own right for combating greenwashing and promoting sustainable investing, the EU Taxonomy has far-reaching implications for several other European ESG-related regulations including the Sustainable Finance Disclosure Regulation (SFDR) and the EBA's Pillar 3 Framework. As their foundation, poor disclosures under the EU Taxonomy will more than likely undermine the quality of other ESG disclosures.

What are the key challenges facing credit institutions?

While there are many complexities in the regulation that impact credit institution, the technical challenges are primarily data related. In order to achieve their EU Taxonomy disclosures, they must first overcome ESG data gaps, inconsistencies, and complex calculation methodologies.

Non-Financial Information

The EU Taxonomy brings a new twist to the type of data required to comply, compared to current regulations with which banks are familiar. They must now collect data related to borrowers and their economic activities – not just financial.

Given the amount of ESG information requested across taxonomy activities, how can institutions discern which data fulfills their calculation and disclosure requirements?

How do they find, collect, and assess it?

Non-Public Information

As expected, little ESG data is publicly available, particularly for private companies, real estate, and other household exposures. Because this data gap results in incomplete disclosures that do not accurately reflect the environmental sustainability of banks' balance sheets, alternate methods of data collection must be investigated.

So, what can be done for institutions with large retail portfolios and/or exposures to private companies?

Source Variations

Even for publicly traded companies, the reliability of market data providers is limited as no two vendors are alike. They use different methods to estimate the alignment of counterparties, thereby producing diverse results. They may provide different Nomenclature of Economic Activities (NACE) code breakdowns for the same counterparty, leading to varying alignment ratios.

How can institutions mitigate the risk of these data inconsistencies on their disclosures?

GAR and Alignment Calculations

Assuming institutions can find all the data needed for their disclosure requirements, they still need to address the minefield of actually assessing their exposures against the EU Taxonomy's Technical Screening Criteria and calculating their GARs. Credit institutions have a constantly growing set of counterparties, of different sizes, operating in different sectors and countries. The alignment calculation methods may also be different depending on the type of counterparty and exposure being evaluated.

How can institutions cost-effectively assess their large number of exposures and counterparties against the nuanced taxonomy requirements to present the most accurate reflection of their sustainability?

What's next?

As part of the ever-changing regulatory environment, there is a growing trend of sustainability developments for credit institutions, both locally and globally. Given the complex and nuanced nature of the EU Taxonomy regulation, a strategic approach that efficiently addresses the associated operational burdens of this and all regulations should be the goal for all institutions.

Such a solution would be adaptive to new market norms, while providing a foundation for the future.

- Easily expanding to cover new regulations
- Facilitating re-use and sharing across data modules
- Scaling to address new data collection, granularity, and volume requirements
- Enabling tactical implementations
- Supporting different calculation methodologies

It is becoming increasingly critical for institutions to make use of all available tools to ease this burden.

Or better yet, a single, jurisdictionally agnostic, modular solution would be a good start.

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