EU Taxonomy Regulation: Are you ready for the first wave of disclosure requirements?

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European regulatory initiatives on Sustainable Finance are progressing at full speed. As part of the broader EU Sustainable Finance Action Plan, EU regulated financial market participants will be required to make their first set of disclosures in line with the EU Taxonomy from January 2022 and throughout the course of the year. Consequently, firms across the industry are preparing for significant investment to ensure EU Taxonomy compliance. This brief paper provides guidance on the expected reporting requirements, key disclosure challenges/ considerations and next steps to enable market participants to prepare an efficient suite of disclosures under the EU Taxonomy Regulation.

What is the EU Taxonomy Regulation?

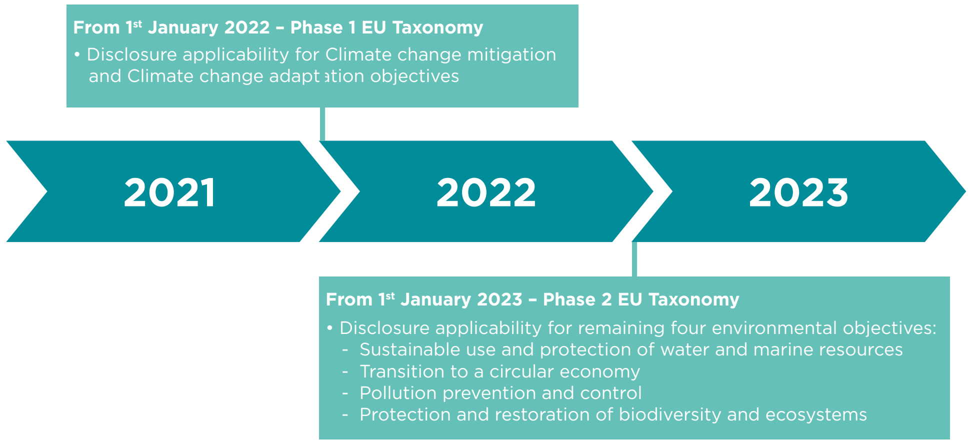
The EU Taxonomy came into force on the 12th July 2020, as part of the EU Sustainable Finance Action Plan led by the European Commission. The objective of the taxonomy is to develop a framework that clearly classifies what economic activities are considered sustainable to support a standard definition of environmental products. By establishing a regional environmental taxonomy, the risk of failing to meet client sustainability expectations and greenwashing is reduced. The framework will also provide more clarity to investors and other stakeholders on the financial products that are truly supporting environmental goals.

The EU Taxonomy Regulation will apply to all market participants offering financial products in Europe, including Banks, Asset Managers, and Insurance companies. Market participants will be required to report the extent to which their financial products align to sustainable guidance of the regulation. In addition to market participants, all companies subject to the Non-Financial Reporting Directive (NFRD) will also be required to disclose the extent to which their own business activities are taxonomy aligned.

The regulation sets out six environmental objectives:

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

On the 21st April 2021 the first delegated act for the EU Taxonomy, covering the climate change mitigation and adaptation environmental objectives, was politically agreed by the European Commission. The delegated act will be formally adopted at the end of May which paves the way for the two phase implementation, with the initial focus on the disclosure of activities linked to climate change mitigation and adaption:



What are the key disclosure requirements for market participants?

The technical criteria for sustainable activity classification will consider prescriptive and tailored indicators that have to be met for each activity type. Market participants will need to:

1. Identify which financial products offered have a mandatory taxonomy disclosure requirement and determine which additional products will be reported on a voluntary basis (if any). Any products which have sustainable investment as an objective, or which promote environmental or social characteristics will require EU taxonomy reporting
2. Assess if the underlining companies in the financial products are engaged in economic activities that are in scope for the taxonomy and if so, if the specific environmental thresholds defined are met
3. For each company in the financial product, extract the proportion of the underlining company revenue or cost (capex or opex) that is linked to taxonomy aligned economic activities
4. Calculate and report the total proportion of underlining investments revenue or cost in the financial product that is taxonomy aligned

Taxonomy alignment example: financial product/fund with three holdings

	Financial Product/Fund		
Company under consideration	Pharmaceutical Company	Electric Car Company	Hydroelectric Power Company
Company revenue that is taxonomy aligned	Manufacture of organic based chemicals 20%	Manufacture of low carbon technology 100%	Electricity generation from hydropower 75%
Weighting of each company as a proportion of the overall product/fund	25%	25%	50%
Calculation of financial product taxonomy alignment	20% x 25%	100% x 25%	75% x 50%
Financial product/fund taxonomy alignment	67.5% Taxonomy Alignment		

To determine whether a product is aligned to the EU Taxonomy Regulation firms must complete technical screening criteria to understand if the product is 'environmentally sustainable', considering 3 principles:

1
Substantial Contribution
To at least one of the six environmental objectives

2
Do no significant harm
Do no significant harm (DNSH) to the other five environmental objectives

3
Meet minimum safeguards
(e.g. OECD Guidelines on Multinational Enterprises and the UN Guiding Principles on business and Human Rights)

For each relevant product, the financial market participant will be required to state how they have used the Taxonomy in determining the sustainability of the underlying investments and detail to what environmental objective(s) the investments contribute.

As well as the obligations under the EU Taxonomy, it is also important for firms to be attuned to other ESG regulatory developments, in particular the Sustainable Finance Disclosure Regulation (SFDR), which also forms part of the legislative measures arising from the European Commission's Action Plan on Sustainable Finance. Despite both regulatory texts being separate, common concepts and terms are used throughout and there is an emphasis, through the recent publication of draft SFDR regulatory technical standards (RTS), that consistency between Taxonomy Regulation and SFDR disclosure should be established. Firms with disclosure obligations under SFDR must ensure that the classification of products, particularly relating to SFDR Article 8 and 9, are consistent with the approach taken to EU Taxonomy disclosure (see appendix for further information on SFDR alignment).

What are some of the key disclosure challenges in the EU taxonomy Regulation?

1.Access to Data

Assessing taxonomy alignment requires substantial company data to determine if the sustainability thresholds are met and to estimate the relevant proportion of revenue or cost that is tied to such activity. In addition, market data may require assurance checks to confirm that metrics collected accurately reflect corporate impact.

2.Sustainability Expertise

The activity alignment assessment requires familiarity with a range of sustainability topics to effectively interpret and evaluate the information reported by companies.

3.Corporate engagement

In many cases, companies do not currently report sufficient information to assess if a criteria can be met or not. Resolving this issue may require direct engagement with a large number of corporates.

4.Alignment with wider ESG regulatory framework

EU taxonomy alignment may impact the categorisation of funds and subsequent reporting under the SFDR regulation. A non-cohesive approach to ESG regulations by market participants can result in implementation setbacks, resourcing challenges, and client suitability risks.

What are the next steps?

The EU Taxonomy RTS were published in June 2020 and are subject to consultation across the industry. Following feedback from stakeholders, as well as discussions with the European Parliament and Council, the first delegate act was politically agreed on 21st April 2021. The act formalises the technical screening criteria to define which activities contribute to the first two environmental objectives: climate change mitigation and climate change adaptation. It is estimated that this delegated act would cover the economic activities of roughly 40% of listed companies, in sectors which are responsible for almost 80% of direct greenhouse gas emissions in Europe. The delegated act will be formally adopted at the end of May 2021, following translations into all EU languages, and market participants are expected to make disclosures in relation to climate change mitigation and adaptation in periodic reports, pre-contractual disclosures, and websites from January 2022 and throughout the course of the year.

What does this mean for UK regulated institions?

UK firms offering products in the European Union will need to comply with the EU taxonomy regulation. Firms offering products to the UK market do not have an EU taxonomy requirement, however the government has confirmed that the UK will implement its own version of the EU Taxonomy Regulation in the future by:

- Taking the scientific metrics of the EU Taxonomy as the basis;
- Having the UK Green Technical Advisor Group reviewing the EU scientific metrics to ensure that they are adequate for the UK market.

How BCS can help?

We can assist organisations with a range of solutions to meet EU taxonomy requirements, specifically:

- Completing pilot assessments on specific funds to inform decision making and support larger scale planning in line with market emerging best practice
- Advising on external data solutions to determine the most useful, reliable, and cost-effective options
- Supporting the development of a documentation review framework for public information analysis, leveraging our research and data capabilities
- Developing an investment engagement model to support the validation of key information not available in public documents
- Advising on screening criteria, activity alignment and financial reporting analysis
- Advising on EU taxonomy and wider ESG regulatory linkages, including SFDR implementation
- Preparing prospectus, website, and periodic disclosure

BCS Consulting has extensive experience supporting financial institutions in ESG capability development and ESG framework adoption. We have assisted clients in a broad range of related ESG challenges, including the development of Sustainable Finance product taxonomies, TCFD reporting, Climate PRA SS3/19 compliance, Stewardship Reporting, SFDR and broader ESG regulatory compliance advisory.

For further information on how we can help your organisation disclose against the EU Taxonomy please contact Hector.Fontaine@bcsconsulting.com, our Sustainable Finance Lead.

Appendix

Financial products developed within the European Union or marketed in the European Union, including pension products, are in scope for the Taxonomy, specifically:

Type of business	Products in scope
Asset Managers and Pension Funds	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

Financial market participants may choose to use the Taxonomy for other product types if deemed useful. The disclosures must be made as part of existing pre-contractual requirements (e.g. disclosure to investors) and periodic reporting requirements (e.g. annual report). These products also carry sustainability disclosure obligations under the SFDR and NFRD regulations.

SFDR alignment

SFDR sets disclosure requirements for market participants to ensure firms assess and evaluate sustainability risks at firm, entity, and product level. The scope considers principal adverse impact disclosure, website product disclosure, product periodic disclosure and pre-contractual product disclosure. SFDR creates three categories of funds based on the approach to environmental objectives within the fund (Article 9, Article 8 and Article 6). The table below outlines the taxonomy disclosure expectations against the three types of funds identified in SFDR.

SFDR Article	EU Taxonomy Rule	Description	Taxonomy Disclosure Expectations
Article 9	Article 5	Financial products which have sustainable investment as their objective.	Must complete Taxonomy disclosures where the investment is on activities that contribute to an environmental objective.
Article 8	Article 6	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.
Financial products not subject to Article 8 or 9	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".

In addition to the alignment between the EU Taxonomy and SFDR surrounding the classification of products which have sustainable investment as an objective, or which promote environmental or social characteristics, firms should also ensure consistency in disclosure for products that do not fall into these categories. Products that do not have a sustainable objective or promote an environmental or social characteristics, 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".

NFRD alignment

NFRD requires large public-interest entities to disclose information in their non-financial statements in relation to Environmental, Societal and Governmental (ESG) matters. Article 8 of the Taxonomy Regulation requires companies falling within the scope of the existing NFRD to report on the extent to which their activities are sustainable. Through the compressive package of measures released by the European Commission on 6th July 2021, a Delegated Act supplementing Article 8 of EU Taxonomy Regulation was adopted. The Act specifies the content, methodology and presentation of information and indicators to be disclosed by financial and non-financial firms within the scope of NFRD.

Non-financial firms

From 1st January to 31st December 2022: shall only disclose proportion of Taxonomy-eligible or non-eligible activities in total turnover, capital and operational expenditure and the relevant qualitative information.

From 1st January 2023: include KPIs and any accompanying information set out in the Annexes to the Delegated Act.

Financial firms

From 1st January 2022 to 31st December 2023: shall only disclose the proportion in their total assets of exposures to Taxonomy non-eligible and Taxonomy-eligible economic activities and the relevant qualitative information.

From 1st January 2024: include KPIs and any accompanying information set out in the Annexes to the Delegated Act.

The European Commission issued a Corporate Sustainability Reporting Directive (CSRD) proposal on April 21st 2021. The proposal extends the scope of the NFRD requirements to include all large companies, whether they are listed or not and without the previous 500-employee threshold, broadening the scope of entities from 11,600 to 49,000. In addition, the Commission is proposing to extend the scope to include Small and Medium-Sized Enterprises that have securities listed on regulated markets, with the exception of listed micro-enterprises. The proposal also introduces more detailed reporting requirements, and a requirement to report according to mandatory EU sustainability reporting standards. Reporting standards could be adopted by the end of 2022 which means firms would apply the standards to reports published in 2024, covering the 2023 financial year.

About the Authors

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Hector is the Sustainable Finance Lead for BCS Consulting. He has deep expertise and significant experience in managing risk and sustainability, gained by supporting a large number of financial institutions. He frequently speaks at industry events and has authored numerous ESG publications and articles, including the BCS Consulting ESG Banking Benchmark Report, the BCS TCFD Global Progress in the Banking Sector Report 2021 and the BCS PRA Dear CEO Letter paper (Managing Climate-related Financial Risks). Hector also holds an APRM qualification from the Professional Risk Managers' International Association.

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Katie is an experienced ESG consultant specialising in the wealth and asset management sector. As well as supporting firms in mobilising ESG operating models, Katie supports firms to develop appropriate regulatory disclosure, including SFDR, TCFD, Shareholder Rights Directive II and The Stewardship Code. Katie co-authored The BCS Accelerating ESG Regulatory Landscape paper in 2020.

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Frank is a Sustainable Finance Consultant with strong risk management and ESG experience, specialising in the wealth and asset management industry. He has worked with firms on upcoming ESG regulatory initiatives, such as the EU Taxonomy, SFDR and TCFD, and has supported firms in understanding the data and operating model considerations to effectively implement ESG requirements.

BCS Consulting is a leading UK provider of management consultancy to the financial services industry and are a 100% employee owned business. Our client portfolio includes a range of multinational and UK banks, asset and wealth managers, insurance firms and payment and card companies.

We are committed to delivering excellence. Nothing less will do. It's the reason why clients across the financial services sector trust us to find the best solutions to the toughest challenges. Commitment runs through our collective nature and it means we work harder to achieve success for our clients and ourselves. Sustainability is vitally important to us and it can be measured in the long-term relationships we build with all those connected with our business.

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