Testing the application of the EU Taxonomy to core banking products:

High level recommendations

January 2021

About the project partners

About the United Nations Environment Programme Finance Initiative

United Nations Environment Programme Finance Initiative (UNEP FI) is a partnership between UNEP and the global financial sector to mobilize private sector finance for sustainable development. UNEP FI works with more than 350 members—banks, insurers, and investors—and over 100 supporting institutions– to help create a financial sector that serves people and planet while delivering positive impacts. We aim to inspire, inform and enable financial institutions to improve people's quality of life without compromising that of future generations. By leveraging the UN's role, UNEP FI accelerates sustainable finance.

About the European Banking Federation

The European Banking Federation (EBF) is the voice of the European banking sector, bringing together national banking associations from across Europe, with active members in 32 countries. The EBF is committed to both promoting a thriving European economy underpinned by a stable, secure and inclusive financial ecosystem, and contributing to a prosperous society in which financing is available to fund the dreams of citizens, businesses and innovators across the globe.

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Views from Banks' CEOs

"The EU Taxonomy will be a game changer on our common path to fulfil the Paris Agreement, and I am convinced that this will lead to a major shift when used in practice. Since banks play a key role in this transition, it is important that the EU Taxonomy recognises the specificities of core banking products, and that compatibility between EU Taxonomy and other applicable regulations is ensured. We are proud of having participated in its development, and as a sponsor of the joint UNEP FI and EBF project, I now look forward to the future work on developing detailed guidelines."

Johan Torgeby, President and CEO at SEB
Chairman of the Executive Board, Swedish Bankers' Association

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"The EU's Sustainable Finance Taxonomy plays a critical role in defining sustainable economic activity within Europe and beyond, thus delivering sustainable finance where it matters most. Standard Chartered's participation in this pilot project has enhanced our preparedness and capacity to support our clients with the EU Taxonomy over the coming years."

Bill Winters, Group Chief Executive, Standard Chartered

"Helping our clients transition towards a sustainable future is a strategic priority for BBVA. Banks can play a key role providing advice and channelling funds to big corporates, but also to SMEs and households. The EU Taxonomy is a fundamental step in this direction and the pilot project promoted by UNEP FI and EBF is a great starting point to test and facilitate its applicability."

Carlos Torres Vila, Chairman, BBVA

“Société Générale is fully supportive of the objective of the EU Taxonomy. Having common definitions is critical for strengthening the confidence of investors in sustainable finance. Industry guidelines will assist the application of the Taxonomy to the specific nature of banking activities and should further reflect transition activities. Over time, the Taxonomy has the potential to become a mainstream tool for steering efforts to reach the goals of the Paris Agreement and inspire methodological convergence across jurisdictions.”

Diony Lebot, Deputy CEO, Société Générale

“At ING we are more than happy to contribute to the development of the fantastic work of UNEP FI and the European Banking Federation on the EU Taxonomy. We see the Taxonomy as a sustainable finance tool not only for asset managers but also for banks, as we can play an important role in financing the transition to a low carbon economy. This will certainly help us in steering our lending portfolio towards the Paris Agreement’s climate goals, which we call our Terra approach.”

Steven van Rijswijk, CEO, ING

“Banks should play a crucial role in accelerating the necessary global transition to sustainable, low-carbon and socially inclusive economies. Our aspiration at Deutsche Bank is to support our clients in their transition. But we also need other stakeholders—and especially the European Union—to pave the way and establish common standards. We were one of the first banks in Europe to operate a taxonomy linked on a best effort basis to the EU Taxonomy, and as one of the sponsors of this UNEP FI and EBF initiative we promote a broader discussion and application of the EU Taxonomy.”

Christian Sewing, CEO, Deutsche Bank

Foreword

"An economy that works for people" is one of the key priorities of the EU Commission and the fundamental concept to underpin social fairness and European prosperity in line with the European Green Deal. Given the transformative power of finance, banks have a special responsibility stemming from their central role in financing the European economy. Their leadership and embrace of sustainability reach in influence also beyond EU borders.

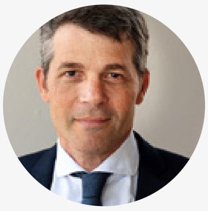
Most companies are at different stages in their sustainability journey and banks' engagement with businesses to support them throughout their transitioning process is key. The decisions banks and their clients make today will steer the economy for years to come and define the societies and the quality of the environment for future generations.

The EU Taxonomy is the backbone of a truly transformative agenda. Consistent, well-founded definitions of sustainable economic activities will increase transparency and are expected to ease the flow of finance to support such activities, enable development of financial products on a level playing field basis and steer sustainable innovation in the economy.

This report is the result of 26 major banks, seven banking associations and five observing organisations working together to test, pilot and assess the complexities of applying the EU Taxonomy to core banking products.

This report is also the result of an unprecedented momentum within the banking industry. Globally, banks are progressively committing to accelerating the transition to a net zero carbon economy. Individually or collectively, banks are setting sustainability targets and aligning their business operations and strategies with the Sustainable Development Goals (SDGs) and the Paris Agreement as demonstrated for example by the 200 signatories to the Principles for Responsible Banking.

The EU Taxonomy sets ambitious goals and challenges to businesses and banks, at lightning speed. This is a learning process for market participants, for governments, for us all. For the best. And we are fully committed to further supporting banks throughout their sustainability journey and towards implementing the EU Taxonomy in line with the European agenda for sustainable finance.



Eric Usher
Head
UNEP Finance Initiative

Wim Mijs
CEO
European Banking Federation

Executive Summary

This report shares key insights from the **first set of comprehensive case studies** on the application of the EU Taxonomy to core banking products, namely **retail banking, Small and Medium Enterprises (SME) lending and corporate banking, including trade, export and project finance.**

From January to August 2020, **26 banks** tested the EU Taxonomy[1] on more than **40 live or recently closed transactions and existing client relationships,**[2] across a large spectrum of Nomenclature of Economic Activities (NACE) macro sectors and economic activities. The testing exercise featured a diverse and balanced range of banking products, client corporate structures and geographical locations.

The exercise took place against the unusual and demanding backdrop of the COVID-19 pandemic, emphasising the important role that banks play in integrating, planning for and addressing sustainability challenges. In parallel with testing the EU Taxonomy, banks continued to effectively engage and support their customers and communities.[3] As this report is made public, some aspects of the regulatory package are yet to be clarified (for example Article 8 of the EU Taxonomy Regulation) and corporate reporting requirements aligned to the EU Taxonomy are still 12 months away from being legally enforceable.

The testing exercise **led to eight recommendations** addressed to legislators, regulators, owners of environmental and social standards and frameworks, labels and certification schemes used by banks, and banks themselves. UNEP FI and the EBF trust that this report will foster confidence and facilitate the implementation of the EU Taxonomy in the banking sector.

Benefits

Banks generally view the EU Taxonomy as a positive initiative to strengthen sustainable finance by bringing **consistency and transparency** to the industry. The vast majority of banks think that a **common set of definitions will enhance** their approach to managing **all aspects of Environmental, Social and Governance (ESG),**[4] including how they interact with clients. Banks believe that, overall, the EU Taxonomy will bring reputational benefits to the industry by **mitigating potential perceptions of greenwashing. Finally, most**

1 In development at the time, see chapter 1 for further details.
2 This took place on an anonymous basis, no confidential client or transactional related details were shared at any point.
3 https://www.unepfi.org/banking/bankingprinciples/covid-19-and-sustainable-recovery/responsible-banking-in-the-covid-19-crisis/
4 It is important to note that in the context of this report, the concept of ESG is used to refer to banks' approaches to managing environmental and social aspects and risks related to the provision of financial services.

banks welcome clear guidance as they seek to identify green assets, set targets and align their long-term business strategies and models with the sustainability transition.

Key benefits of applying the EU Taxonomy
1. Leveling the playing field in the banking industry and reputational enhancement, i.e. "reducing greenwashing".
2. A homogenous and rigorous evaluation of clients' environmental performance.
3. Supporting bank-to-client engagement efforts and bringing direction and confidence to banks' clients.
4. Increased business opportunities and potential increased demand for sustainable finance products.
5. Boosting the availability and quality of corporate data for sustainability.
6. Supporting harmonisation of reporting.
7. Fostering coherence and alignment with national and international standards.

Challenges

While testing the application of the EU Taxonomy, banks faced a number of challenges. The application of the EU Taxonomy to retail loans, trade finance transactions and general purpose facilities—the latter constituting well over 50% of a typical bank's balance sheet/revenue stream—was particularly testing for banks, **which nonetheless managed to develop early stage methodologies to address these specific challenges. The availability and quality of data** and information proved to be the most difficult challenge in evaluating Do No Significant Harm (DNSH) criteria, particularly when segmenting alignment by turnover/revenue and in the alignment of SMEs and non-EU based assets. Finally, banks anticipated **operational complexities** in assessing and classifying multisector clients, managing increasing in documentation requirements and upgrading IT processes.

Main challenges found when testing the EU Taxonomy to transactions and clients	
Type of challenge	**Details**
Unspecified use of proceeds	Classifying and assessing the transaction accurately according to business activities.
Data	Data availability, quality, granularity, comparability, standardization, relevance, verification and handling time, particularly for: **Retail clients and SMEs:** complexity, lack of resources, expertise and incentives. **Non-EU based assets:** lack of regulatory alignment and incentives. **Do No Significant Harm and social safeguards(DNSH) and Minimum Social Safeguards (MSS):** lack of evidence of alignment, insufficient granularity. **Adaptation related data:** availability and lack of common methodology and tools to perform Climate Adaptation assessment. **Segmentation by turnover or revenue:** data is limited and often does not match Taxonomy classification requirements.
Operational	1. Linking EU Taxonomy classification by economic activities to clients' business activities including: ▪ Use of NACE classification differs from existing practices; ▪ Mapping between NACE and existing classification schemes; ▪ Application of NACE at single entity level; ▪ Inconsistencies amongst EU Taxonomy application methodologies developed by banks and across industries; 2. Increased documentation, monitoring and time necessary to complete and monitoring use of proceeds. 3. Adaptation of internal information processes: cost of development of IT tools, lack of common nomenclature necessary for data collection and automation 4. Increased complexity leading to risk of errors of inconsistent application of the EU Taxonomy 5. Traditional external supporting services and tools suitable only for small share of transactions
Meeting clients' needs	Uncertainties regarding banks' capacity to best meet clients' preferences such as loans to support their transition path e.g. Sustainability Linked Loans, may not be fully addressed.

Steps and principles for practical application

Banks found that adopting the following steps helped to apply the EU Taxonomy to core banking products:

Step 1: As far as possible, define the use of proceeds of the loan or credit facility.
Step 2: When use of proceeds is not specified, classify exposure on the basis of clients' business activities.
Step 3: Decide into which Taxonomy category the transaction, activity or company falls - Mitigation, Adaptation, Enabling, Transitioning, etc.
Step 4: Require clients to disclose the necessary information to meet Technical Screening Criteria (TSC) and MSS.
Step 5: TSC for Substantial Contribution should be strictly met based on evidence.
Step 6: Subject to a materiality judgement, DNSH and MSS assessments may rely on assumed compliance of clients and assets with relevant legislation. They may also rely on certification schemes and labels and require timing flexibility. Indeed, it may be challenging to conclude assessments before transactions are finalised.

Recommendations

Audience	Recommendations
Legislators and regulators should	
Recommendation 1	Take into account the **specificities of core banking products** which may limit a full application of the EU Taxonomy.
Recommendation 2	Ensure **consistency and compatibility/comparability of criteria** between the EU Taxonomy and other applicable legislation and regulations, including at national level.
Recommendation 3	Seek **global alignment of taxonomies**, facilitate international data collection and provide comparability mechanisms of criteria for **applicability of the EU Taxonomy beyond EU borders**.
Recommendation 4	Consider and seek **to address the timing mismatch** between corporate data availability and banks' ability to apply and disclose against the EU Taxonomy.
Recommendation 5	Facilitate the collection and **handling of data**, through the **development of tools** to facilitate the application of the EU Taxonomy.
Owners of standards and frameworks, labels and certification schemes should	
Recommendation 6	**Clarify alignment** with the EU Taxonomy.

Banks should	
Recommendation 7	Start **methodical data collection** for taxonomy-relevant information **as part of new origination**, on a best effort basis, based on internal strategy and priorities.
Recommendation 8	Devise **industry guidelines** for the implementation and application of the EU Taxonomy to core banking products, in conjunction with relevant industry bodies.

Next steps

The objective of the testing exercise was for participants to develop an initial and practical understanding of the applicability of the EU Taxonomy to banking products. Now that this has been successfully achieved, banks are embarking on the next stage and will now focus on devising guidelines and methodologies, as well as engaging with the Sustainable Finance Platform and other stakeholders, to support the delivery of the recommendations contained in this report.

Disclaimer:

This report proposes recommendations and guidance to banks willing to apply the EU Taxonomy. It does not offer an interpretation of the EU Taxonomy Regulation or any other Regulation herein mentioned. It also does not constitute an injunction for banks to apply such guidance.

This report represents the overall view of the members of the Working Group. However, although it represents such a consensus, it may not necessarily, on all details, represent the individual views of member banks, observers and banking associations. Where views diverge significantly, it is signaled in footnotes. This report does not reflect the views of UNEP FI, the EBF or the authors.

26 published case studies[i]

Banking products

- Mortgages/retail loans
- Corporate loans incl. general purpose loans and loans with UoP
- SME loans
- Green bonds
- Syndicated credit facility, RCF
- Sustainability linked loans
- Export finance guarantee, project finance
- Trade finance guarantee, supply chain finance

EU Taxonomy alignment

- Strictly aligned:[ii] 0
- Aligned with assumptions:[iii] 7
- Partially aligned:[iv] 8
- Not aligned or not aligned yet: 4
- Inconclusive: 7

Sectors

- Real estate
- Transportation
- Manufacturing
- Forestry
- Energy
- Telecoms

Geographies

- EU based (75%)
- Non-EU (25 %)

KEY:

i. The total number of case studies used to inform the report is larger and based on over 40 live or recently closed transactions and existing client relationships.

ii. No assumptions made, all relevant data available

iii. Aligned with Assumption: SC TSC could be ascertained through available data, compliance with MSS and DNSH could not be ascertained through available data but was assumed, in alignment with relevant regulatory obligations that the company / asset has to follow.

iv. Partially aligned: Only some of the TSC for SC and/or DNSH and/or MSS could be ascertained, and the use of assumption was not possible, for a variety of reasons. See details for each case study outcome.

Overview of published case studies:

	Bank	Product	Sector	EU Based	Outcome
Retail Lending	BNP Paribas	Mortgage loans to individuals Link to case study	Real Estate	√	**Not aligned yet:** no clear definition of NZEB, no data available on Energy Efficiency in the Banks' systems and the local or national information on EPC's and the "top 15 %" is not available.
	BNP Paribas	Retail loan for electric vehicles Link to case study	Transportation	√	**Partially aligned:** Substantial contribution criteria are met. DNSH and segmentation data not available. Minimum Social safeguards assumed to be complied with.
	CaixaBank	Mortgage loans to individuals Link to case study	Real Estate	√	**Partially aligned:** The mitigation criteria could be satisfied with the help of existing EPC system in Spain but the fulfilment of the DNSH criteria cannot be positively evidenced.
	Credit Suisse	Mortgage loans to individuals Link to case study	Real Estate	Switzerland	**Inconclusive**: Data typically collected from mortgage borrowers during the credit approval process is currently insufficient to meet the full Taxonomy requirements.
SMEs	BNPP	SME Loan for freight transport services Link to case study	Transportation	√	**Partially aligned:** meets TSC for substantial contribution, compliance with social safeguard is assumed, DNSH assessment and segmentation too challenging to perform.
	Nordea	SME general purpose loan for acquisition of additional forest land. Link to case study	Forest & Agriculture	√	**Partially aligned**: use of FSC/PEFC certification to meet criteria for sustainable forest management but insufficient evidence for other TSC (carbon sink), DNSH and social safeguards.

	Bank	Product	Sector	EU Based	Outcome
Corporate Banking	Swedbank	General Purpose Corporate Loan-Revolving Credit Facility to a leading biogas group consisting of biogas CHP plants and an agricultural company. Link to case study	Power & Agriculture	√	**Aligned with assumptions:** As the company is located in the EU, it was assumed the customer is complying with EU and local regulations, therefore not all DNSH categories were thoroughly analysed.
	SEB	General Purpose Corporate Loan-RCF to a Large Cap forest industry company Link to case study	Forest & Agriculture	√	**Aligned with assumptions:** Difficult to calculate the turnover/proceeds from the standing forest since the value chain of the forest to the end-product remains within the company and use of proceeds is unknown.
	FMO	Senior debt secured corporate financing forestry and timber product business Link to case study	Forest & Agriculture	Africa	**Not aligned yet:** Borrower involved in several activities, turnover / CAPEX information not available at that level; difficulties to identify which of Mitigation or Adaptation objective is the most appropriate. Impossibility to assess climate risk at portfolio-level.
	Natixis	General purpose corporate loan- RCF to automotive sector company Link to case study	Transportation	√	**Not aligned:** TSC for substantial contribution are not met.
	Natixis	Green bond to finance new electrified metro lines and stations. Link to case study	Transportation	√	**Aligned with assumptions:** TSC for Substantial contribution are met, DNSH and minimum social safeguard require some assumptions.

	Bank	Product	Sector	EU Based	Outcome
Corporate Banking	OP	Green loan following LMA Green Loan Principles. Proceeds are used for modernizing an existing CHP (combined heat and power) Link to case study	Energy	√	**Not aligned yet:** It is not clear whether a CHP plant using small quantities of fossil fuels in the mix would be eligible under the climate change mitigation taxonomy. Compliance with DNSH was assumed through application of Finnish and EU regulations .
	Piraeus Bank	Long term credit lines to develop and operate renewable energy sources. Link to case study	Energy	√	**Aligned with assumptions:** Gap due to the company following ISO 14001 & 50001 and not ISO 14067 or providing a GHG PCF Assessment.
	Société Générale	The case study focuses on the application of the EU taxonomy on the Power Generation portfolio. Link to case study	Energy	√	**12% of the portfolio is aligned with assumptions:** (A stricter reading of the taxonomy would bring this number to 0%). 52% does not meet TSC for substantial contribution. 36% does not meet TSC for DNSH.
	KBFG	Loan to a solar power plant Link to case study	Energy	Asia	**Aligned with assumptions:** data related to carbon emissions were missing to assess the alignment of the threshold in accordance with Mitigation criteria
	Intesa San Paolo	Inaugural syndicated two-tranche credit facility, ESG linked financing. Link to case study	Energy	√	**Inconclusive:** difficulties linked to unknown use of proceeds and client operating across several industry segment. Granular data per economic activity was no available.

	Bank	Product	Sector	EU Based	Outcome
Corporate Banking	ING	Revolving Credit Facility (RCF), linked to the external ESG rating of the client Link to case study	Real Estate	√	**Aligned with assumptions:** The client meets the TSC for mitigation for energy compliant with TSC for DNSH and social safeguards is expected given the company follows EU laws.
	BPCE	Corporate Loan to public transportation company Link to case study	Transportation	√	**Partially aligned:** TSC for substantial contribution are partially met (assumed rated of 62%) whilst DNSH could not be evidenced (lack of data) and Social Minimum Safeguards were not reviewed.
	BBVA	Green Bond Link to case study	Telecoms	√	**Inconclusive:** Difficulties with 1) matching client activity with economic activity of the EU Taxonomy; and 2) assessing climate change monitoring solutions. This economic activity is still under review by the TEG/Sustainable Finance Platform.
	BBVA	KPI Linked Facility (Sustainability Linked Loan) for utility provider Link to case study	Energy	√	**Inconclusive:** Insufficient information publicly available.
	BPCE	Corporate Loan to rental accommodation company Link to case study	Real Estate	√	**Partially aligned with use of assumptions:** 50% of new build stock and 50% of existing stock are aligned according to the company NFRD report. Used assumptions for DNSH and MSS. Data lacking especially for DNSH criteria for adaptation, water and pollution control..

	Bank	Product	Sector	EU Based	Outcome
Other corporate banking products	Crédit Agricole	Export finance: ECAs-guaranteed buyer credit to finance an EPC contract awarded to a European company for a large hydropower dam. Link to case study	Energy	Emerging markets	**Inconclusive but potential alignment over time:** Data yet to be provided through ongoing studies. Substantial contribution to Mitigation will occur once E&S action plans are implemented.
	DB	Trade finance: guarantee facility to a mid-sized corporate client in the manufacturing & engineering industry Link to case study	Manufacturing	√	**Inconclusive:** Due to the absence of reporting requirement for mid-sized companies. Depending on the use of proceeds, in this transaction, some guarantees are aligned, others are not, and for the rest it was not possible to conclude because of lack of relevant data.
	Natixis	Trade finance: Low-carbon aluminium supply chain financing instrument. Link to case study	Manufacturing	North America	**Inconclusive:** Publicly available information is not sufficient. Alignment with TSC for substantial contribution, DNSH and social safeguards is likely but should be evidenced.
	Natixis	Project Finance for offshore wind farm in UK Link to case study	Energy	UK/Europe	**Partially aligned:** meets TSC for substantial contribution in full, meet TSC for DNSH partially (it does not meet DNSH for water), compliance with minimum social safeguard is partial, segmentation is not an issue since the financing goes to a single Project.
	SCB	Project finance for a solar power plant Link to case study	Energy	Middle East	**Aligned with assumptions:** TSC for DNSH to Adaptation could not be evidenced.

Key:
Aligned with Assumption: SC TSC could be ascertained through available data, compliance with MSS and DNSH could not be ascertained through available data but was assumed, in alignment with relevant regulatory obligations that the company / asset has to follow.

Partially aligned: Only some of the TSC for SC and/or DNSH and/or MSS could be ascertained, and the use of assumption was not possible, for a variety of reasons. See details for each case study outcome.

Introduction

The EU is committed to achieving ambitious climate and energy targets by 2030, in line with the UN 2030 Agenda, the Sustainable Development Goals (SDGs) and the Paris Agreement. The EU's long-term strategy is to achieve net-zero Green House Gas (GHG) emissions by 2050. In 2018, the European Commission published an **Action Plan on Financing Sustainable Growth**, built on recommendations made by the High-Level Expert Group to develop an EU strategy on sustainable finance. The Action Plan sets out three objectives:

1. Redirect capital flows towards sustainable investment;
2. Mainstream sustainability in risk management;
3. Foster transparency and long-termism.

The EU Taxonomy forms part of the implementation of the **Action Plan on Financing Sustainable Growth**. In July 2018, the European Commission set up the TEG to assist in developing:

1. An EU classification system to determine whether an economic activity is environmentally sustainable;
2. An EU Green Bond Standard (EU GBS);
3. Benchmarks for low-carbon investment strategies;
4. Guidance to improve corporate disclosures of climate-related information.

The EU banking sector has a major role to play in the transition of the European economy to a carbon-neutral society, given banks **represent around 80% of the external funding of the EU economy**. Banks see the EU sustainability agenda as an opportunity to further promote the role of the sector within the society and align its interest and strategies with clients, investors, employees, and society in general. They view climate change as a global challenge, requiring a global response for which the current global pandemic and economic crisis have reinforced the urgency of meeting this challenge.

EU banks are **fully committed to accelerate this transition,** as shown in the recent signing of the Principles for Responsible Banking and Collective Commitment to Climate Action[5] (CCCA) initiative,[6] under the umbrella of the UNEP FI.

The EU Green Deal will transform all industries and the EU economy. Rapidly changing business models demand flexible capital solutions. As a result, companies are required, under the EU Taxonomy Regulation, to disclose their percentage of revenues from sustainable activities, and associated capex and opex (see Annex 3). Banks can start playing a role in this transformation by advising companies on the sustainability aspects of their capital structures and appropriate financing instruments to support existing and new sustainable activities. **The objective is not to "label" banking products**

5 Link to Principles for Responsible Banking : https://www.unepfi.org/banking/bankingprinciples/
Link to CCCA: https://www.unepfi.org/publications/banking-publications/collective-commitment-to-climate-action-year-one-in-review/

6 The CCCA encompasses six actions, including priority n°1: "Focusing our efforts where we have or can have the most significant impact, i.e. initially focusing on the most carbon-intensive and climate-vulnerable sectors within our portfolios, which are key to the transition to a low-carbon economy and to building resilience in the most climate-vulnerable communities"; and priority n°2: "Engaging and working with our clients on their transition. As banks, this is how we can contribute most effectively to realizing the changes required in the real economy to achieve a low-carbon, climate-resilient economy."

and services as sustainable but to contribute in a meaningful way, via products and services, to a transformation of companies and the EU economy as a whole. After advising the company on the sustainability aspects of their capital structure, banks will usually offer appropriate products and services. These products may be labelled or earmarked as "sustainable", if that is important for commercial reasons, or when necessary for banks' sustainability disclosures under the EU Taxonomy Regulation.

In this context, the EBF and UNEP FI launched a project to **assess the extent to which, and how, the EU Taxonomy may apply to core banking products,** for banks that wish to engage with the Taxonomy.[7]

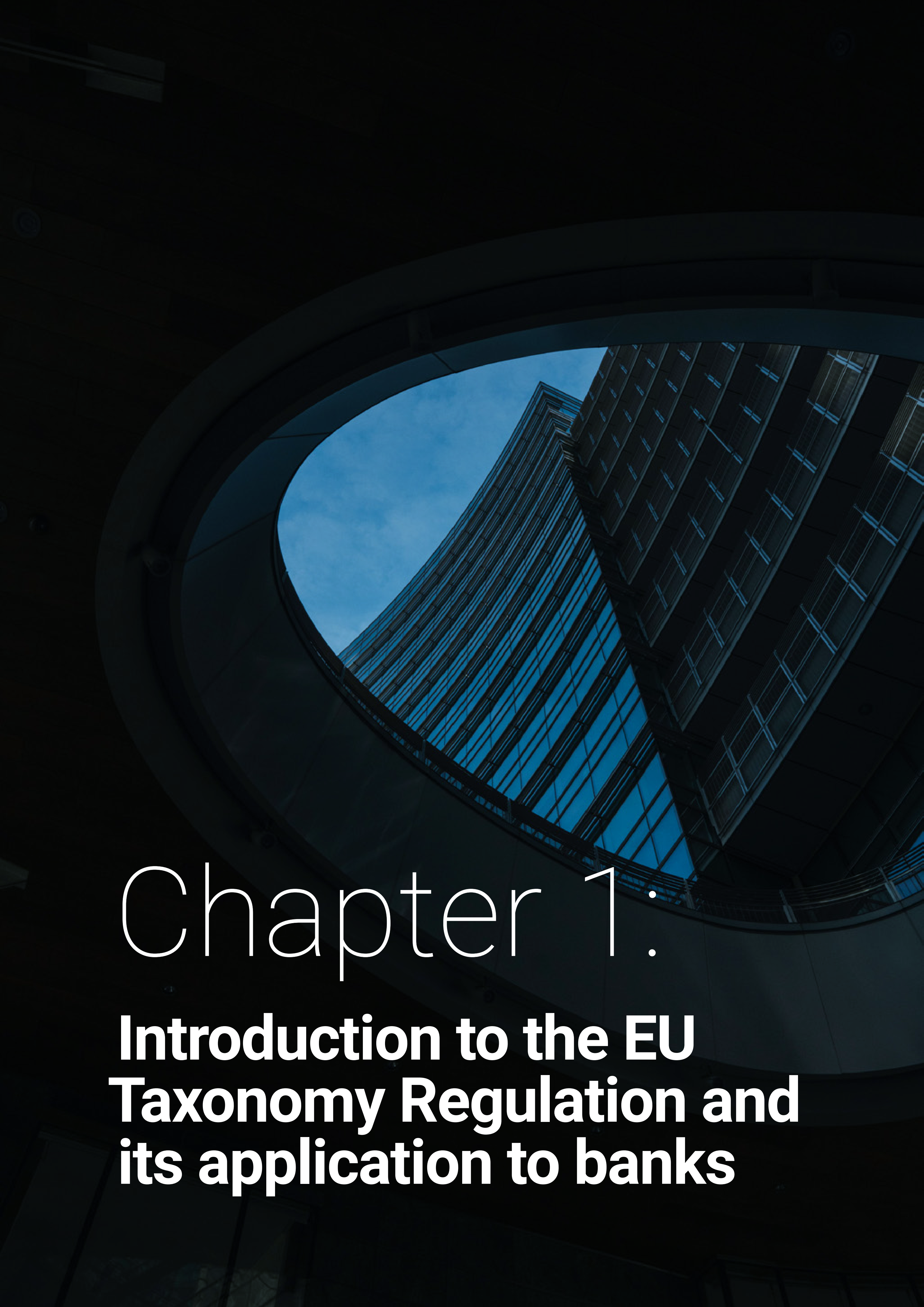
Some 26 banks participating in the project were invited to consider how their existing approach to sustainable finance may benefit and/or be challenged by the imminent introduction of the EU Taxonomy. From March to August 2020, they **tested the EU Taxonomy on more than 40 live or recently closed transactions and existing client relationships,**[8] across a large spectrum of NACE macro sectors and economic activities, and a diverse set of banking products, clients' corporate structures and geographical locations.

This report shares **key insights** from the information collected, focussing on the **benefits and challenges** experienced by banks in the application of the EU Taxonomy to core banking products. Banks also proposed **high level principles to follow** in order to apply the EU Taxonomy to **retail banking, SME lending and corporate banking, including trade, export and project finance**. These insights fed into a **set of recommendations** directed to legislators, governments, regulators, owners of industry standards, and finally, to banks themselves.

It should be noted that, while this report represents the views of the majority of banks that participated in the project, some banks do not plan to use the EU Taxonomy beyond its strict mandatory scope.

7 According to the text of the Commission's proposal, the scope of the regulation does not cover banks' lending or risk management on the whole balance sheet.

8 This took place on an anonymous basis, no confidential client or transactional related details were shared at any point.



Chapter 1:

Introduction to the EU Taxonomy Regulation and its application to banks

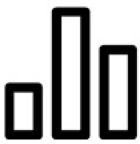
1.1 The EU Taxonomy Regulation

The EU Taxonomy Regulation,[9] adopted by the European Parliament and Council in June 2020, is a regulation that establishes a classification scheme for economic activities based on their environmental sustainability. This classification scheme is primarily aimed at supporting mandatory disclosures, in order to help investors and companies make informed decisions on "environmentally sustainable economic activities."[10]

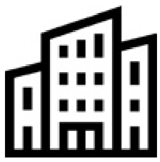
In its initial stage of development, the EU Taxonomy has focused on climate change Adaptation and Mitigation. A comprehensive Taxonomy covering all six environmental aspects, including water, the circular economy, pollution prevention and control, and protection of ecosystems, will be adopted by the end of 2021.[11] A summary of key elements of the classification scheme is available in Annex 1.

1.2 Disclosure requirements specific to the EU Taxonomy Regulation

The EU Taxonomy Regulation introduces mandatory disclosure requirements that target **three groups of users,** as illustrated below:[12]



1. Financial markets participants offering financial products in the EU, including operational pension providers



2. Large companies who are already required to provide a non-financial statement under the Non-Financial Reporting Directive; and

3. The EU and Member States, when setting public measures, standards or labels for green financial products or green (corporate) bonds

9 Regulation (EU) 2020/852 of the European Parliament and Council, 18 June 2020, on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088, is known as the "Taxonomy Regulation". The classification scheme within the regulation is known as the "EU Taxonomy". Link to the Official Journal: https://op.europa.eu/en/publication-detail/-/publication/e5ba36a8-b454-11ea-bb7a-01aa75ed71a1/language-en

10 EU Technical Expert Group on Sustainable Finance (2019), Using The Taxonomy, p.3

11 The Commission will adopt delegated acts containing specific TSC to supplement the principles set out in the regulation and to determine which economic activities can qualify for each environmental objective based on the final report of the TEG. The criteria for climate change mitigation and adaptation will be adopted in Q1 2021 (as per timeline in page 22 below) and the criteria on the other four environmental objectives (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) by the end of 2021.

12 EU Technical Expert Group on Sustainable Finance (2020), Technical Report, p.26

For the banking industry, **up to two types of mandatory disclosure requirements are** introduced:

1. **Article 8**, which requires banks to report **"how, and to what extent, their activities are associated with Taxonomy aligned activities"**[13] in connection with the Non-Financial Reporting Directive (NFRD). This disclosure requirement also applies to non-financial institutions, which are expected to report their alignment with the EU Taxonomy both in terms of proportion of revenues or turnover, and capex and opex.[14] Disclosure(s) should be made as part of non-financial statements, either from annual reports or dedicated sustainability reports.[15]
2. **Article 6 introduces an additional product-level disclosure requirement in alignment with the Regulation on Sustainability-Related Disclosures in the Financial Services Sector (SFDR).**[16] These requirements are applicable to Financial Market Participants[17] that market or manufacture financial products in the European Union. Products in scope are pensions and asset management products;[18] insurance-based investment products; and **Corporate & Investment Banking products including securitisation funds, venture capital and private equity funds, portfolio management, and index funds.** Individual financial instruments, such as bonds, are not directly included in the EU Taxonomy disclosure obligations.[19]

For these products (under point 2 above), financial market participants are required to state:

- how and to what extent they have used the EU Taxonomy in **determining the sustainability** of their 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.

13 EU Technical Expert Group on Sustainable Finance (2020), Technical Report, p.27
14 As explained in annex 1 part IV: Attributing EU Taxonomy alignment in terms of turnover, capex and opex.
15 Level 2 legislation detailing the requirements for both financial and non-financial companies is expected to be finalized by 1st June 2021 with public consultation on the draft delegated act having taken place over the summer of 2020.
16 Regulation (EU) 2019/2088 and EU Technical Expert Group on Sustainable Finance (2020), Technical Report, p.37 & 38.
17 Defined as "an insurance undertaking which makes available an insurance-based investment product (IBIP); an investment firm which provides portfolio management; an institution for occupational retirement provision (IORP); a manufacturer of a pension product; an alternative investment fund manager (AIFM); a pan-European personal pension product (PEPP) provider; a manager of a qualifying venture capital fund registered in accordance with Article 14 of Regulation (EU) No 345/2013; a manager of a qualifying social entrepreneurship fund registered in accordance with Article 15 of Regulation (EU) No 346/2013; a management company of an undertaking for collective investment in transferable securities (UCITS management company); or a credit institution which provides portfolio management". Point (1) of Article 2 of Regulation (EU) 2019/2088.
18 These are defined as "a portfolio managed in accordance with MiFID; an alternative investment fund (AIF); an IBIP; a pension product; a pension scheme; a UCITS; or a PEPP". Point (12) of Article 2 of Regulation (EU) 2019/2088.
19 "Individual financial instruments, such as bonds, are not captured in the definition of financial products and are not directly required to disclose against the Taxonomy." EU Technical Expert Group on Sustainable Finance (2020), Technical Report, p.9.

In alignment with the SFDR, the disclosure for a product or offering is either mandatory or on a comply-or-explain basis, depending on the type of sustainability claim, as follows:

Article SFDR	Description	Obligation
Article 9	Financial products which have sustainable investment 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 of in combination with other characteristics.	Must complete Taxonomy disclosures where environment 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".

Table: Disclosure obligations based on type of sustainability claim

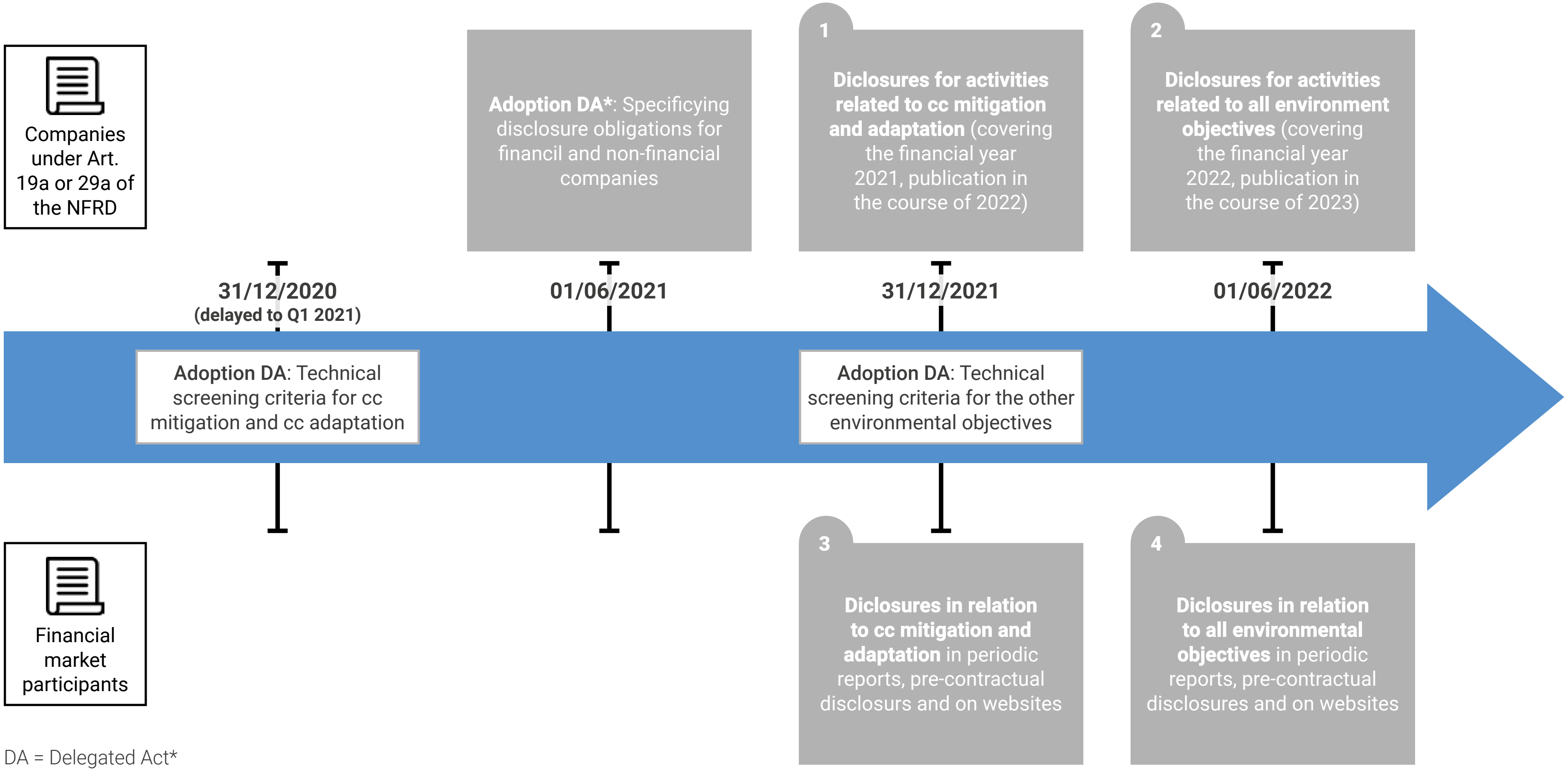
Disclosures must be made as part of existing pre-contractual and periodic reporting requirements. These products (as described in the table above) also carry sustainability disclosure obligations under the SFDR, such as subsequent disclosure on financial market participants' websites.[20]

It is notable that the EU Taxonomy Regulation does not currently require external verification or assurance of related disclosures. However, issuers do have existing obligations for the presentation and accuracy of their reporting. This will be reviewed by 2022.

20 Article 10 of Regulation (EU) 2019/2088.

Legislative process, current status and milestones for the legislation

The EU Taxonomy Regulation has now been adopted and is published in the Official Journal. The following timeline[21] outlines the different EU Taxonomy Regulation disclosure requirements for companies that fall under the NFRD and for financial market participants:



DA = Delegated Act*

21 EU Technical Expert Group on Sustainable Finance (2020), Technical Report, p.26

The timeline shows that:

- TSC for Mitigation and Adaptation will be issued as part of the explicit European Commission legal requirements by the end of 2020 (delayed to Q1 2021);
- Financial market participants will be required to complete their **first set of EU Taxonomy linked disclosures by the end of 2021**, covering activities that substantially contribute to climate change mitigation and/or adaptation.

Further details on the NFRD and information on transparency and disclosure requirements applicable to banks undertaking EU Taxonomy disclosures is available in Annex 4.

1.3 EU initiatives and legislation potentially encouraging further use of the EU Taxonomy

EU Green Bond Standard

The European Commission mandated the TEG to develop a proposal for an EU GBS. The TEG published its final report in June 2019, with recommendations on principles as well as a draft model of an EU GBS. It proposed that any type of listed or unlisted bond or capital market debt instrument issued by a European or international issuer and aligned with the EU GBS should qualify as an EU Green Bond.

The proposed draft model links the use of proceeds of EU Green Bonds to the EU Taxonomy Regulation. Though use of the EU GBS remains voluntary at this point, **issuers of Green Bond(s) that wish to adopt the label 'EU Green Bond' are required to align the use of proceeds to the EU Taxonomy.** Issuers that do not wish to adopt the label can opt for other capital market options.

The European Commission held a public consultation on the potential adoption of the EU GBS. After evaluation of the public feedback and an internal impact assessment, the EC has been tasked to make a legal proposal for an EU GBS by June 2021.

Green labels on financial products and EU Ecolabel

There are currently eight sustainable finance labels on the EU market, with three distinctive groups:

- ESG-led labels, such as LuxFLAG ESG in Luxembourg and Umweltzeichen in Austria, which must guarantee that financial products rely on an integrated ESG strategy;
- Green Labels, such as the French GreenFin label or LuxFLAG Climate Finance, which are awarded to so-called "green" thematic environmental funds; and
- Norms or quality standard frameworks for funds claiming to be sustainable, socially responsible, such as Towards Sustainability, launched by the Belgian Financial Sector Federation, Febelfin.

Once they are applied by market participants, it is expected that these labels will relate to, or align with, the EU Taxonomy classification. This is particularly the case for those currently relying on pre-existing green finance frameworks, such as the Climate Bonds

Initiative. Moreover, **EU Member States are now required by the EU Taxonomy Regulation to use the EU Taxonomy when creating labelling schemes for green investment products and corporate bonds**.

In addition, the European Commission is currently developing the **EU Ecolabel criteria** for retail financial products, such as equity funds, bonds funds and saving accounts. The proposal suggests that the EU Ecolabel would be awarded to the manufacturer of green financial product(s) as opposed to the financial product itself. **The EU Ecolabel uses the EU Taxonomy as the basis for its criteria** and is only awarded when a minimum threshold of taxonomy eligible activities is reached.

EBA and ESG Pillar III disclosures

The European Banking Authority has developed a discussion paper on ESG risk management and supervision as a preparatory step for the issuance of a comprehensive report on the integration of ESG risks into banks' and supervisors' practices, due in June 2021.[22]

> **"The discussion paper makes a number of references to the EU Taxonomy when it can potentially be relevant to banks' approach to ESG factors and risk. Examples include the role the Taxonomy could play as part of a portfolio's alignment methodologies, as a way to measure or mitigate ESG risks, or the role of the Taxonomy when banks consider the development of sustainable products as one of the tools to adapt their business models and strategies, with a view to ensuring a long-term resilience aligned with public policy objectives"**
>
> European Banking Authority

22 https://eba.europa.eu/sites/default/documents/files/document_library/Publications/Discussions/2021/Discussion%20Paper%20on%20management%20and%20supervision%20of%20ESG%20risks%20for%20credit%20institutions%20and%20investment%20firms/935496/2020-11-02%20%20ESG%20Discussion%20Paper.pdf

EU Climate Bank: European Investment Bank Group support to the Banking Sector to encourage the use of the EU Taxonomy

In June 2019, the European Council called on the European Investment Bank (EIB) to step up its activities in relation to climate change. A few months later, the EIB announced an ambition to reach 50% climate action and environmental sustainability financing by 2025. The EIB Group (EIBG) committed to invest EUR1 trillion in these financing areas by 2030. Delivering on this commitment requires a clear set of definitions to track performance and robust systems for monitoring and reporting. **The EIB is therefore aligning its tracking methodology to the EU Taxonomy.**

Work on the EIBG climate action definitions is underway, and will need to ensure that EU Taxonomy TSC are reflected in EIB definitions. Still, the joint multi-lateral development banks methodology and EIB-specific criteria will continue to be used for sectors not covered. Further, and specifically for SME financing through financial intermediaries, the EIBG may adopt simplified criteria where necessary, while making appropriate references to the EU Taxonomy such as the climate-tracking methodology developed under the InvestEU programme.

The Climate Bank Roadmap—the EIB's plan to achieve its climate ambition—includes two initiatives that are expected to promote the EU Taxonomy:

Development of Green Bond and Green Loan products

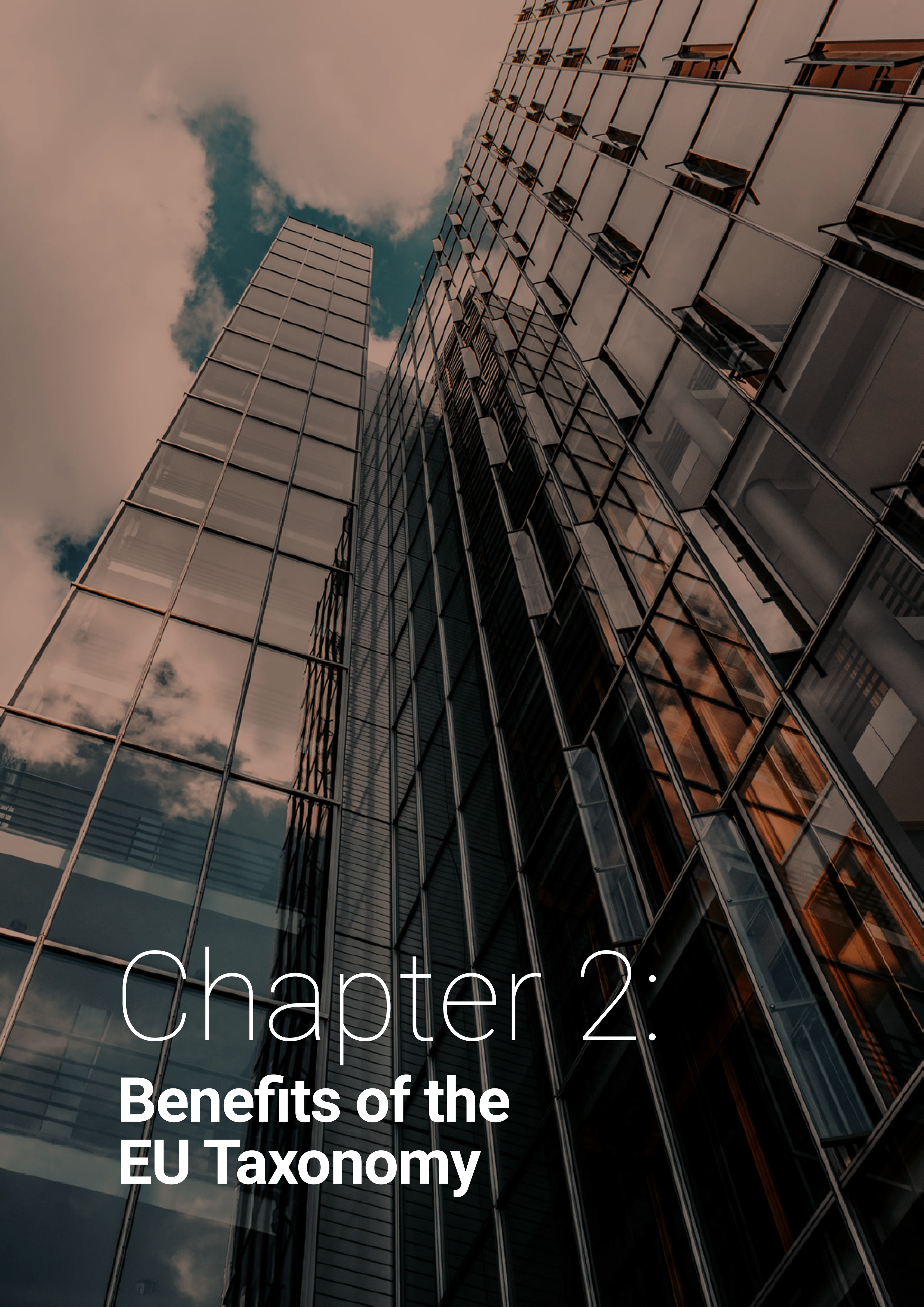
Alongside mainstreaming Green Bonds, the EIB is developing a Green Loan product. These will reference the EU GBS, the International Capital Market Association (ICMA) Green Bond Principles and Loan Market Association (LMA) Green Loan Principles, but will also **champion the adaptation of the EU Taxonomy with the new green debt providing a framework to track and trace green investment.** Importantly, **the green debt offer will be complemented by a technical assistance/advisory proposition.**

Eligibility criteria for green products will be aligned with the Climate Bank's new green definitions and actions to simplify sub-loan allocation processes and improve product effectiveness. In addition, the EIB is exploring thematic financing offers, such as for energy efficiency in the housing and industrial sectors. Support solutions for financial intermediaries include a **"Climate Portal"**, accessible through EIB's website. The portal allows wider EIBG partnering with financial intermediaries, contains e-learning modules, a document library, and eligibility checking and reporting tools.

Enhancement of European Investment Fund intermediated debt financing products

The European Investment Fund (EIF) will provide support for green projects including guarantees, counter-guarantees and credit enhancement. Projects in scope will accelerate the transition to green energy production and low carbon emissions transport, and reduce greenhouse gas emissions and energy consumption.

Through **InvestEU**, the EIB is likely to be an implementation partner for 75% of EU guarantees. In addition, the Commission plans to launch a **climate-tracking methodology, which will benchmark financing operations against the InvestEU programme**. It plans also to put in place 'sustainability proofing', under which projects above a certain size must assess their environmental, climate and social impacts. **The initiatives will make appropriate use of the EU Taxonomy**, as stated in the Commission's Communication on the Sustainable Europe Investment Plan in January 2020.



Chapter 2:
Benefits of the EU Taxonomy

Banks participating in this study identified a number of key benefits to the application of the EU Taxonomy.

Levelling the playing field in the banking industry and reducing "greenwashing"

By establishing a common set of definitions and thresholds for sustainability performance that are publicly available, the EU Taxonomy will bring **consistency, transparency and comparability across the banking industry. This should be a significant mitigating factor against the risk of being perceived as "greenwashing" and help to reduce reputational risk for banks and liability risk for all stakeholders.**

> **"The EU Taxonomy will help to increase transparency and will foster the transition towards less risky business models, de facto de-risking the loan books."**
>
> Intesa Sanpaolo

A homogenous and rigorous evaluation of clients' environmental performance

Banks welcome the clarity and rigour engendered by the use of thresholds and TSC. The required segmentation process, using turnover, opex and capex,[23] will bring a homogenous approach across the banking sector to evaluating clients' sustainability performance. The overall aim is to support better comparability among clients and sharpen banks' understanding of how their clients align with EU sustainability objectives.

A number of participating banks see the EU Taxonomy as an opportunity to strengthen their risk management processes and provide more structure and resilience to their management of environmental and social risks, including their due diligence processes.[24]

> **"The EU Taxonomy is a very good tool for assessing alignment with CO_2 reduction from a science-based perspective. The level of granularity renders a very high level of trust and reduces the risk of greenwashing. Having applied the Taxonomy on this case, we believe that it will definitely be a tool for reorienting capital flows, increasing transparency and supporting risk management in a more holistic way."**
>
> SEB

23 This does present a sizeable operational challenge for banks, as described in chapter 3.

24 This is not a unanimous position and some banks prefer to develop a separate internal framework. The topic of risk management will not be expanded on as it is out of the scope of this project and is being specifically examined by the EBF Task Force on ESG risks.

Supporting bank-to-client engagement efforts

A consistent set of definitions for economic activities, along with environmental impacts and benefits, **will provide banks and their clients with a common language** that will facilitate banks' engagement efforts with their clients. Engagement with clients represents an important channel through which banks can deliver on their sustainability commitments. Overall, **banks feel that the EU Taxonomy will help them to understand their clients better in terms of sustainability.**

> **"The EU Taxonomy provides concrete guidance for what can be considered sustainable economic activities, and provides both a risk management angle as well as opportunities for customer dialogue."**
>
> Nordea

Bringing direction and confidence to banks' clients

The EU Taxonomy will bring **clear guidance and confidence** to banks' clients as they seek to identify green assets, set targets and align their long-term business strategies and business models to the energy transition.

> **"The thresholds are clear cut, easy to use and thus give our clients the opportunity to benchmark with peers."**
>
> Natixis

Reputational enhancement and increased business opportunities

Banks see the EU Taxonomy as a way to show they positively contribute to the economy and the energy transition. Banks further see an opportunity to develop a competitive advantage by offering, for example, advisory services on the basis of their understanding of the EU Taxonomy.

> **"We learned how to apply the calculation principles of emissions on a multi-fuel CHP plant and we can now offer clients support, not only on the EU Taxonomy but also on estimation of emissions according to upcoming regulations."**
>
> OP Financial Group

The EU Taxonomy may also increase sales opportunities through partnerships with international financial institutions and enhancement of export competitiveness. Eventually, it should help to attract more overseas investment.

Potential increased demand for green and sustainable finance products

The EU Taxonomy may **reduce environmental uncertainties and information asymmetries** for retail investors and therefore increase their confidence when making investments. Heightened transparency around assets, use of Ecolabels and standards related to the EU Taxonomy, and better access to green products, may raise awareness among retail investors. The EU Taxonomy has the potential to enhance certainty and confidence in the retail segment, as the framework is shared by all investors and will carry the 'approval stamp' of the EU.

Boosting the availability and quality of corporate data for sustainability

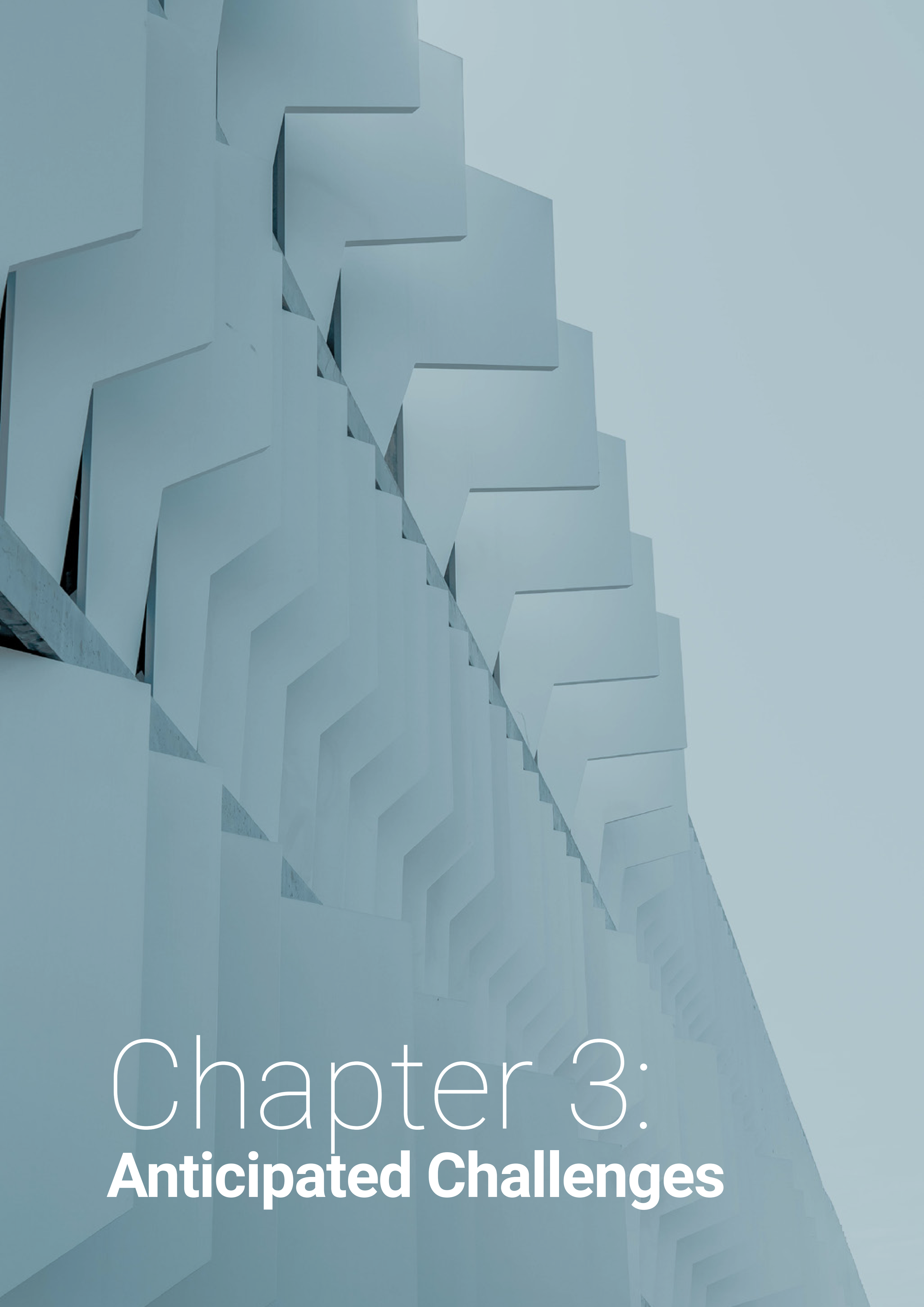
Whilst the EU Taxonomy is making the challenge of data availability more prominent, this issue has always existed and has, at times, been a limiting factor for banks. The EU Taxonomy Regulation is expected to drive better data availability from corporates and banks' clients.

Harmonisation of reporting

The EU Taxonomy will become a key reference classification scheme for several regulatory frameworks, such as the NFRD. Where applicable, this will foster **consistency and harmonisation of reporting requirements through the financing value chain**, from loan origination to refinancing (EU Taxonomy, EU climate benchmark, climate-related disclosures and EU GBS).

Coherence and alignment with national and international standards

Banks welcome **the efforts made towards the overall alignment and coherence of the EU Taxonomy with existing international standards and frameworks.** These are often routinely used by banks and include the OECD Guidelines on Multinational Enterprises, the Guiding Principles on Business and Human Rights, and the IFC Performance Standards. However, alignment is sometimes insufficient on the level of thresholds and metrics. This is an area to be improved over the next few years, as outlined further on in this report.



Chapter 3:
Anticipated Challenges

A number of challenges are identified in case studies used to test the application of the EU Taxonomy to more than 40 transactions and clients. While some are generic, others relate to specific banking products.[25]

This chapter provides an overview of the challenges identified by banks and a high-level gap analysis for existing and relevant practices and the requirements of the EU Taxonomy.[26]

3.1 Key challenges identified when testing the application of the EU Taxonomy to transactions and clients

3.1.1. Unspecified uses of proceeds

One of the most anticipated challenges is the evaluation of EU Taxonomy alignment when the use of proceeds of a loan or transaction is not specified. Loan proceeds means all amounts advanced as part of a loan, whether advanced directly to the borrower or otherwise. Companies often have general credit facilities in the form of general purpose loans or revolving credit facilities (RCFs). These are used by companies to cover diverse corporate expenditures and are not solely related to specific capital investments. The products provide companies with flexibility to finance their day-to-day operations.

Loan proceeds used for general purposes undermine the assessment of alignment against the EU Taxonomy. Taking the example of a corporate loan used by a large corporate client for daily cash flow management: Will the loan be directed at cash flow management for the Group entity which takes the loan facility, and whose activities encompass multiple types of infrastructure projects located in different parts of the world? Or will the proceeds go towards cash flow management for one of its subsidiaries that constructs commercial buildings in an EU country? Which business activity should be selected to assess alignment with the EU Taxonomy? Indeed, if the proceeds are directed to the subsidiary, and the turnover and revenues of the subsidiary are not disclosed, how is the alignment of the loan segmented with the EU Taxonomy at corporate level?

To put the challenge of unspecified use of proceeds further into context: **general purpose corporate loans and RCFs represent the majority of banking transactions in terms of volume and bank balance sheets.** This is therefore likely to be the most significant challenge faced by banks in the application of the EU Taxonomy to banking products.

25 Some are also specific to industry sectors (business activities) that are financed by banks. However, the scope of this study is core banking products and therefore while challenges related to specific industry activities are not covered in this report, they are embedded in product-related considerations.

26 Practices aiming to integrate environmental and social considerations into financing decisions, sometimes known as ESG practices or Environmental and Social Risk Management practices. Note that both concepts imply different approaches. However, there are no strict industry definitions to formally differentiate these practices.

As the questions above demonstrate, this challenge brings **related complications:**[27]

1. **Classifying transactions accurately according to business activities**
2. **Segmenting alignment based on turnover or revenues**

3.1.2. Data-related challenges

A further significant challenge mentioned by banks when applying the EU Taxonomy to their transactions or portfolios is the **availability of reliable data to inform the TSC.**

It is important to note that, at the time of writing this report, companies were not legally required to disclose information that is specifically aligned to EU Taxonomy requirements.[28] Data available to banks at the time the case studies were conducted was typically data made available by companies on a voluntary basis, either publicly or directly, and data made available by larger companies that fell under the scope of the NFRD.

Besides data availability, other challenges include: Quality, comparability, standardisation, relevance, verification, and time to achieve acquisition. Challenges relating to data go beyond climate mitigation and adaptation and may be exacerbated when the subject matter is complex or demands sector expertise, such as relating to the circular economy or biodiversity.

Specific categories of data-related challenges are discussed below.

Data and information pertaining to SMEs

Smaller counterparties are generally not in a position to disclose relevant data. **SMEs lack the resources, expertise, regulatory pressure[29] and incentives to produce the data necessary to inform the TSC.** Publicly available data on SMEs, whether produced by the company or from an independent source, are high level and often insufficient to provide an appropriate assessment against the EU Taxonomy. SMEs are generally not accustomed to collect the level of information required, as they typically focus on conforming to local legislation and permits. While international or national certificates and labels for climate and environmental purposes carry useful information, they are not specifically related to the EU Taxonomy.[30,31]

As a result, assessing the alignment of SME business activities against the EU Taxonomy often relies on manual and individual intervention that is inefficient and costly, both for SMEs and banks. This **will result in an increase in product and transactional costs, while SMEs need to execute transactions rapidly and in a cost-effective way.**

27 Further discussed in the Operational Challenges section.
28 Further discussed in Annex 1
29 The NFRD does not currently apply to SMEs.
30 For example, ISO standards and product-related labels e.g. UE Ecolabel, TCO, Blue Angel, etc.
31 Certificates may not be SME or economic activity specific, such as joint or umbrella certificates.

> **"Whilst the EU Taxonomy is still beneficial for SME lending, implementation challenges need to the addressed. The Taxonomy is far too technical for SMEs to adopt and requires significant simplification. Nuances for the SME segment need to be addressed and alternatively we need guidelines for the use of third party certification."**
>
> Danske Bank

Data and information pertaining to non-EU based assets:

While EU-based companies are subject to the NFRD, non-EU based companies do not have a legal incentive to generate relevant data. Even when extensive technical documents are available, such as an ESIA,[32] alignment cannot be established, as is demonstrated in the example of project financing for a solar power plant in Oman, where climate adaptation is not addressed.

This question of regulatory alignment outside the EU is all the more significant because non-EU based institutional or retail investors may not be interested in EU Taxonomy-compliant products in the short term. In other words, non-EU based companies are unlikely to be incentivised to align with the EU Taxonomy, or even to publish data to allow an assessment to be made. Finally, there is also the issue of having to apply the TSC to emerging market-based assets, potentially highlighting lower environmental and social performance. This is an undesirable outcome that non-EU based companies will seek to avoid.

> **"At the moment the EU Taxonomy requirements are more suited to managing risks than identifying opportunities. Investors and corporates outside the EU may need significant support in understanding and taking advantage of the EU Taxonomy to ensure financing is available for sustainable activities."**
>
> Standard Chartered Bank

Data and information availability for DNSH, Minimum Social Safeguards and Segmentation by turnover or revenues are limited and patchy

EU-based companies and assets are subject to EU laws and regulations[33] that are also the basis for DNSH TSC and MSS. However, **banks have generally struggled to find evidence of alignment with DNSH TSC and MSS in publicly available data.** The level of granularity required is typically not available, even via paid sources such as ESG data &

32 Environmental and Social Impact Assessment.
33 Implemented at national level.

rating providers. It is unclear whether these external data providers will be able to adapt to the EU Taxonomy requirements. There are a number of limitations, such as the coverage of listed companies and their reliance on corporate reporting that lacks granularity and a focus on assets (except for Green Bond issuance, for example).

The requirement to routinely collect data at this level of precision and granularity is a step change for banks. As an example, even for Green Bond transactions, where information and disclosure are a pre-requisite, and among the most extensive requirements, the prospectus[34] did not say if the company fulfils the requirements of EU water legislation.

There appear to be **three interlinked causes:**

- Information and possibly underlying data do not exist;
- Information is not readily[35] available to banks;
- Information required is complex and difficult to use for non-subject matter experts.

Another example is the case of a project finance transaction for wind and solar power plants based in the EU, in which the information available neither allowed a resilience assessment under DNSH to Adaptation, nor an assessment of DNSH to circular economy. The latter could only be partially evidenced as a percentage of recyclable materials. Moreover, this is a product where available documentation and information are among the most comprehensive among banking products. This points to the fact that for some DNSH TSC and MSS, requirements, relevant **data is likely not produced by, or available to, companies in the first place**, as opposed to only being a question of whether banks are given access to it.

This poses a further question: **Will banks have sufficient leverage** to obtain data from clients that is not commonly produced or available through non-financial data suppliers? The question cannot yet be answered, as the NFRD is yet to enforce disclosure feeding into the EU Taxonomy. It will nonetheless be a significant question in the early years of EU Taxonomy implementation.

At this point there is anecdotal evidence[36] that identifying **data to assess against TSC for DNSH is more challenging for circular economy, ecosystem and adaptation**. With respect to MSS, banks have struggled to find evidence that companies follow the **OECD Guidelines on Multinational Enterprises**. This contrasts with data available to assess substantial contribution which has been more commonly available.

> **"We were uncertain of the level of alignment with the OECD Due Diligence model that was required. Also, how specific the due diligence process has to be in relation to a specific economic activity (when the company's processes are communicated on entity level)."**
>
> SEB

34 Legal documentation ensuring disclosures for bond/fixed income transactions.
35 This refers to information available in the public domain and/or in clients' information records held by the banks.
36 Provided by the case studies of this project.

In particular, **adaptation-related information is more difficult to find than mitigation-related** information, where carbon emissions data now have a significant track record. There is little reliable data and literature on the physical consequences of climate change. Therefore, it may be challenging to evaluate whether an economic activity delivers all possible efficiencies when it comes to Adaptation.

Banks found little evidence to support judgements on the qualitative application of DNSH to Adaptation. There is **no common methodology, tool or database to perform climate risk and adaptation assessments**. This may have significant implications, such as disputes erupting with clients, particularly if it impacts the pricing of the loan.

Finally, there are several cases in which **data exists, but the publicly available version is not granular enough**. For example, banks will have access to overall GHG emissions intensity figures for an aluminium smelter outside the EU, but will not have access to the scope 1, 2 and 3 breakdown.

> **"Applying the DNSH assessment in scale will be very challenging as it requires multiple qualitative assessments and special expertise. Also, differences in interpretations between countries and/or regions may exist. Missing criteria for the rest of the environmental categories (e.g. circular economy, ecosystems) may reduce investments into them. Bridging guidance and support, while waiting for the actual taxonomy, might be needed."**
>
> OP Financial Group

3.1.3. Operational challenges

Together with the challenge of finding relevant data, banks will also face operational challenges.

Assessment and classification processes

The operational reality is often more complex than that captured by the EU Taxonomy. Linking the EU Taxonomy classification system to economic activities brings operational challenges for banks. For example, borrowers' activities may be connected to several EU Taxonomy economic activities. In such cases, banks need to **perform and store several assessments for a single client**, one for each of the economic activities in which they are involved. Further**,** the standard process is to either look at a company in its entirety or **distinguish** a company's business activities based on the legal entities related to the Group. Conversely, the EU Taxonomy looks at economic activities based on NACE, an industrial classification. Therefore, **banks need to "break up" their clients' businesses in a different way from existing industry practice.**

As illustrative example is a general purpose loan to a single client entity that may be used to finance forest expansion, forestry product manufacturing, as well as bioenergy and co-generation from forestry products. This will trigger assessment for several business activities: 4.8 production of electricity from bioenergy; 4.20 cogeneration of heat/cool and power from bioenergy; and 4.24 production of heat/cool from bioenergy. In addition, the loan will require that the client's business is divided in a way that is not easily supported by bank's existing data processes.

> **"The main issue that we foresee for the application of the EU Taxonomy to lending is related to the fact that the EU Taxonomy thinks in terms of economic activity, while we analyse our corporate counterparts by looking at the company overall, not making distinctions (or having a complete data set for each economic activity that allows us to make a full analysis) between all of the economic activities in which they are involved."**
>
> **Unicredit**

The use of NACE classifications for economic sectors brings additional complexities. Non-EU based banks, and some EU banks, use the International Standard Industrial Classification of All Economic Activities (ISIC, maintained by the United Nations Statistics Division) for their internal classification, rather than NACE. Many EU-based banks also use a national classification system. As it stands, identifying clients and transactions in portfolios will require some EU banks and all non-EU based banks to develop a complex **mapping between NACE and ISIC**[37] **and national classification systems.** The issue is compounded by inevitable updates of each classification system, leading to additional complexities in attempting to classify economy activities consistently across portfolios.

The practical application of NACE to banks' processes means codes are applied to single legal entities. There is currently no possibility of splitting the turnover of a single legal entity in order to assign more than one NACE code. Consequently, the bank selects the NACE code that best matches the business model of the legal entity, while **minor activities performed by the same legal entity are not captured.** This has direct implications for a wholly accurate segmentation of turnover by economic activities, as defined in the EU Taxonomy. This issue is exacerbated by the fact that corporates and SMEs will often follow national classification schemes, and may find it challenging to classify their economic activities according to NACE.

Documentation, monitoring and time needed to complete transactions

Another operational issue is the **management of increased documentation requirements.** Loan documentation records use of proceeds and any information deemed essential to the contract between the bank and the client, and will therefore become an important part of the process in the application of the EU Taxonomy. At this point, standard documentation is insufficient to assess and monitor alignment of client business

37 This is the object of a recommendation in chapter 5.

activities with the EU Taxonomy.

Despite the availability of documentation, tracking use of proceeds remains difficult, particularly in complex group structures. Loans may fund several business lines within the group entity that acts as the borrower, or funds may be used for multiple purposes, both equally difficult to track.

Increased documentation requirements will impact the time needed to complete transactions, whatever their degree of complexity. In some cases, **the EU Taxonomy assessment will take longer to complete –** due to the time required to collect relevant information - than **the time available to complete a transaction**. Most clients are eager to receive their loan as quickly as possible and may be reluctant to support a due diligence process, or even simply answer additional questions that would delay the process. This **could become a competitive disadvantage** for banks, especially **when clients have the option to use non-EU based banks**.

The burden on processes must be absorbed by banks' IT infrastructure

Anticipating the implementation of the EU Taxonomy, most banks cite the **challenge of adapting internal information processes and the cost of developing IT tools and support**. However, not all banks regard this as a significant challenge and approaches vary, from adapting existing IT infrastructure to building new standalone systems.

Some banks argue that adapting new data flows into existing internal processes is very time consuming, and question the extent to which it will be possible to move away from manual handling. This in turn raises the question of associated costs, to both banks and customers. Some banks envisage these costs to be significant enough to affect product viability.

> **"Lending products offered as "green" need to be identifiable through links to flags or ratings in underlying systems. These systems will also need to adapt to changes in taxonomies or even multiple taxonomies over time. This is true for both investment funds and balance-sheet products and will require material implementation efforts."**
>
> **UBS**

A **common nomenclature will be required for** companies to structure their disclosures and facilitate the automation of data extraction and aggregation. This will enable them to report accurately on voluntarily-labelled products, for example "EU Taxonomy compliant" products, and to comply with future regulatory constraints such as "green asset ratio(s)."[38] Currently this nomenclature does not exist.[39] Existing processes for manual reporting, aggregation and disclosure of sustainable finance data are not viable options. The percentage of errors and the costs to report on EU Taxonomy alignment in sustainable lending will be too high. As the EU Taxonomy NACE approach is incomplete, with some sub-activities lacking a NACE code, the only option is **harmonised data collection** with a clear nomenclature.

> **"Banks need not only a (1) Taxonomy but also a (2) Nomenclature, in order to automate sustainable finance lending activities and perform an automated assessment of the 'green asset ratio'."**
>
> ING

3.1.4. Increased complexity and risk of inconsistencies

Overall, banks will have to cope with more extensive, demanding and complex assessment processes. Currently, there is a broad spectrum of practices in terms of the depth and refinement of existing internal green taxonomies and ESG screening processes, in particular regarding the use of metrics and thresholds. Both constitute helpful foundations to build on. However, the EU Taxonomy goes well beyond existing internal taxonomies and Environmental and Social Risk Management (ESRM)/ESG frameworks, particularly when it comes to the depth of criteria and systematic use of thresholds and metrics.

> **"We note how demanding the combination of screening criteria for DNSH and Minimum Social Safeguards is when compared to other industry standards/guidelines."**
>
> Natixis

One example is that banks struggled to identify the environmental objectives of clients and assets. This makes it **challenging to determine whether a client or transaction might provide a substantial contribution towards either mitigation or adaptation**. The case of forestry is illustrative, as it could relate to Mitigation, through carbon sequestration. Yet it could also apply to Adaptation, through fostering resilience and preservation of ecosystems, diversification of forest-based income sources (e.g. bioenergy), new

38 Green asset ratio(s) remain conceptual at this stage and are expected to be subject to further definitions. It is expected to lead to disclosure of the share of a bank's assets considered green, using the EU Taxonomy economic sectors and TSC, such as the ratio included in the Non-binding Guidelines on non-financial reporting: Supplement on reporting climate-related information, which proposes the following definition: "Volume of financial assets funding sustainable economic activities contributing substantially to climate Mitigation and/or Adaptation (absolute figures and compared to total exposures) according to the EU Taxonomy". https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52019XC0620%2801%29

39 EU member states possess similar information in a structured way but it is incomplete and not aligned with the EU Taxonomy. For further information consult the report on Joint JRC - EBA workshop on Banking Regulation and Sustainability pp 18-19 https://publications.jrc.ec.europa.eu/repository/bitstream/JRC119403/jrc_eba_workshop_-_report_final_version.pdf

species selection and risk management, through afforestation, reforestation or forestry management practices.

Traditional support tools and services are not well suited to support the application of the EU Taxonomy

Services traditionally used for environmental and social assessments and client monitoring, such as **verification and external expertise, can only support a small share of transactions.** Further, the extent to which external validation of compliance with the EU Taxonomy is a viable option remains unclear, as the **reliability of data presented by clients cannot be guaranteed.** A company's own assessment of its EU Taxonomy alignment would probably benefit from third party verification, though this may precipitate a further challenge, with banks facing differences in data quality that impact the comparability of portfolios. Finally, not all clients (particularly SMEs) will be willing to incur the cost of third party verification. **How these issues will eventually be resolved can significantly impact the level of consistency in the application of the EU Taxonomy to core banking products.**

Segmentation and classification by economic activities may lead to inconsistencies across the industry

Segmenting alignment with the EU Taxonomy makes it difficult for banks to match the EU Taxonomy classification of economy activities with turnover or revenue figures provided by companies, as these figures are often presented in aggregate. Conversely, where more granular data is available, **the segmentation of turnover, revenues, capex and opex figures reflects the legal structure of a group as opposed to its classification by economic activity as per the EU Taxonomy**. Where borrowers do provide more detailed data, it is important that the format is standardised and consistent across different sectors to facilitate comparability, and avoid inconsistencies in how banks' portfolios reflect their alignment with the EU Taxonomy.

A further and partially-related challenge is the classification of corporate clients when their operations encompass multiple sectors.[40] Allocation of exposure to one or several economic sector(s), as per the EU Taxonomy, is complex as this exposure has to be segregated from the rest of the client's business activities.

Some banks are managing the issue by limiting the application of the EU Taxonomy to products and transactions with known use of proceeds. Applying the segregation exercise to all clients would be too demanding for banks aiming to report on exposure across their entire credit portfolios, as it would mean artificially splitting the business of each client across several economic activities. Therefore, in most cases, time and resources are invested only in the largest corporate clients.

This raises the issue of a lack of common methodologies, and the need to ensure consistency across the banking sector to preclude the risk that the same company is not classified in the same way from one bank to another. As a result, reported exposures and green ratios may not be fully comparable and may lead to a distorted view of funding directed to Mitigation and Adaptation.

Uncertainties

Client preferences may not be fully addressed through the EU Taxonomy, as it focuses more on green or sustainable share of revenues and less on approaches, such as engagement strategies or **transition support**.

> **"The EU Taxonomy is an excellent tool, but not broad enough in its current format to cover all relevant sectors and transition metrics. When looking at our portfolio, the EU Taxonomy provides good guidance to approximately 30% of the sector metrics we need. The rest needs to be developed internally to have a holistic approach that works with customers."**
>
> **SEB**

Banks have addressed these needs through Green Bonds, Green Loans and Sustainability-linked loans products. For Green Bonds and Loans, the focus is on climate mitigation, and in most cases they follow the Green Bond and Green Loan Principles. Banks see these references as essential, because they address international markets in which most of them operate, even when based in the EU. The lack of clarity over how these frameworks will conform to the EU Taxonomy creates some **uncertainty as to how banks will be able to support and meet their clients' needs.**

40 This issue comes up when the use of proceeds of a transaction is unspecified, which is a significant share of a bank's balance sheet.

> **"The final report [on the EU Taxonomy] does not consider transition activities (no intermediate thresholds that would allow to identify activities in transition). Yet, their inclusion would (i) encourage emitting companies to embark on a decarbonization trajectory and (ii) redirect financing towards the identified decarbonized activities."**
>
> Société Générale

Further, banks are concerned about the value attributed to their efforts and contribution in financing climate change transition and adaptation. Finally, it appears that uncertainties over the actual requirements to adopt the EU Taxonomy may lead to inconsistent application across the banking industry.

The implementation of the EU Taxonomy is **likely to be driven by a reporting requirement such as the "green assets ratio"** through NFRD and/or Article 8 of the EU Taxonomy Regulation. The implementation of the EU Taxonomy may need to be rolled out across the portion of the balance sheet corresponding to the final requirements. Data and processes would require a larger scope and be equipped to deal with more complexity, as they **would cater for a variety of assets, including non-EU based assets.**

Corporate clients that integrate sustainability into their business strategies may drive application of the EU Taxonomy, because they increasingly **demand sustainable financial products that provide preferential terms and/or reputational benefits.** Indeed, some industries, such as commercial real estate, already see borrowers promoting the green credentials of buildings to prospective investors and clients, alongside lending conditions or green financing products. If cases such as these become more common, the implementation of the EU Taxonomy would likely be more **focused on identifying top performers across a selection of industries, and less on addressing compliance across the eligible client base.**

Banks clearly see the opportunity for market practices to be aligned to increase comparability. Developing methodologies for the application of the EU Taxonomy to different products at industry level will be critical to avoid a lack of operational consistency.

> **"We are absolutely in favour of coherence [in the market] with a common framework and a common language. Financial institutions need it badly and should definitely do it, even though they may not be [ultimately] fully aligned with all criteria and technical definitions."**
>
> Crédit Agricole

3.2 Gap analysis between current practices and EU Taxonomy requirements

Banks have evaluated the gap between their existing practices and internal processes and EU Taxonomy requirements. The higher the bar, the bigger the gaps are, as per the following scale:

1. **No gap**
My bank's requirements and the EU Taxonomy are closely aligned except for the odd insignificant variation

2. **The gap is small**
The gap can be closed without too much investment, time or effort

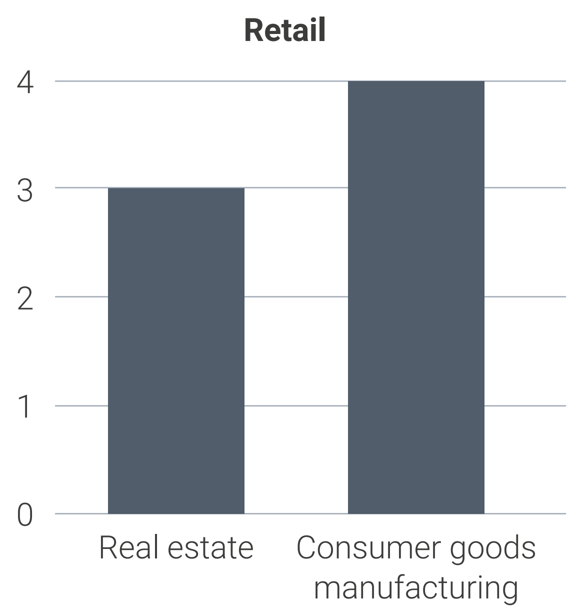
3. **There is a clear gap**
The gap is not small, but it is not huge/unmanageable

4. **The gap is significant**
Aligning to the EU Taxonomy thresholds will require either significant financial investment in our internal processes or significant progress in data availability, or both.

The diagrams below present the average responses from a group of 25 banks and do not represent a statistical evaluation. They show general trends from which individual bank's positions may vary significantly. Finally, they represent views and subjective high-level evaluation about the gap that may exist between each bank's existing internal framework to manage environmental and social aspects in banking products and the requirements of the EU Taxonomy.

Retail lending

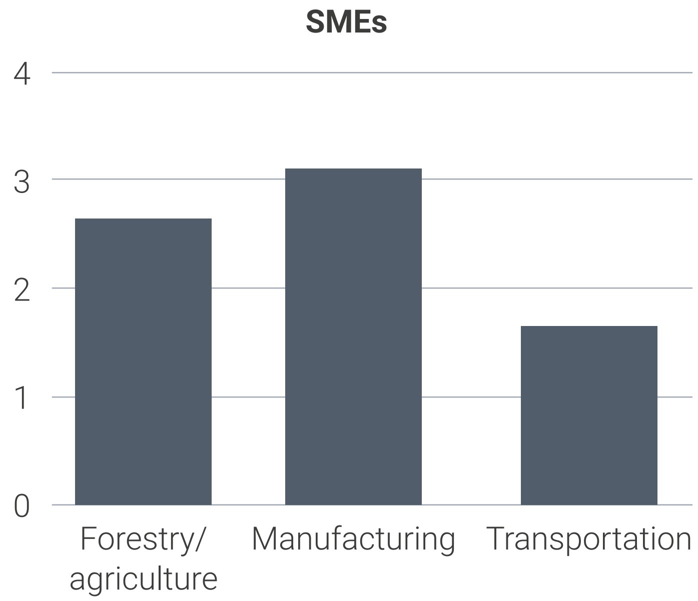
Retail lending is where banks see a wide gap between their existing practices and internal framework, and the EU Taxonomy. The unanimous view is that the EU Taxonomy was not devised for the retail banking market and the processes required to apply it are not suited to the features of retail lending products. However, the issues appear less acute for some industry sectors, such as real estate, where the Environmental Performance Criteria (EPC) rating scheme will facilitate the application of the EU Taxonomy. Nonetheless, while this is helpful in order to meet Substantial Contribution TSC, it does not cover TSC for DNSH or MSS requirements.



SME lending

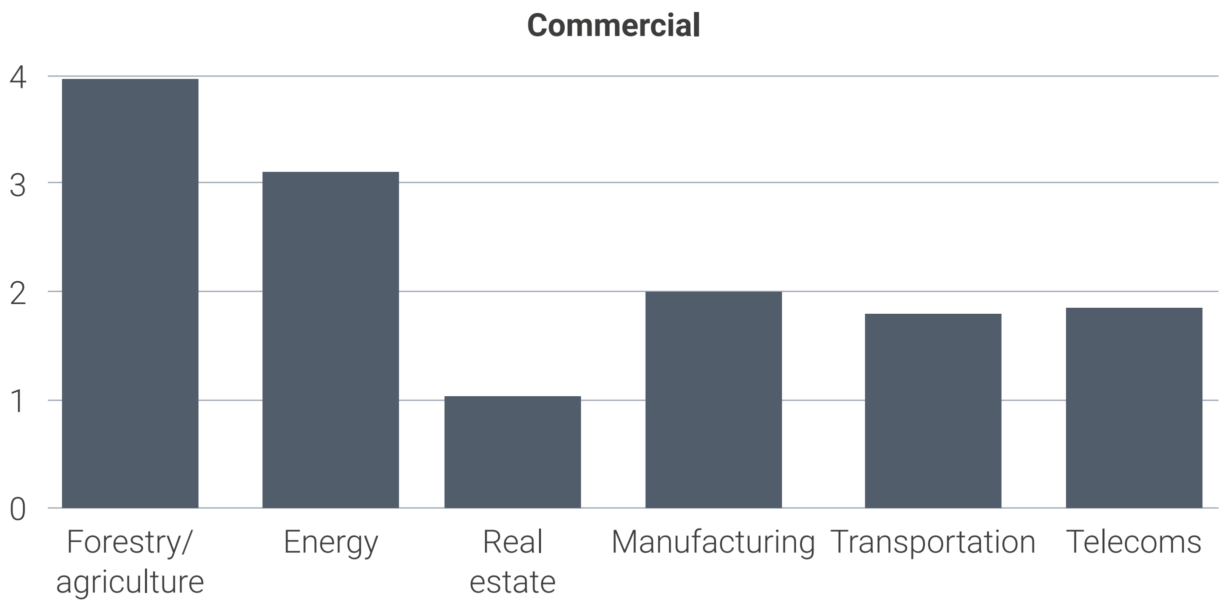
While SMEs are a more obvious target for the EU Taxonomy than household retail customers, the challenges are similar - primarily a lack of suitable available data, linked to the absence of regulatory demand for it.

Banks will need the support of labels and certification schemes to assess SME alignment with the EU Taxonomy. However, many SMEs will struggle to cover the financial cost of this support.



Cases reported for the manufacturing sector are related to assets outside the EU, where data issues will be exacerbated.

Corporate lending



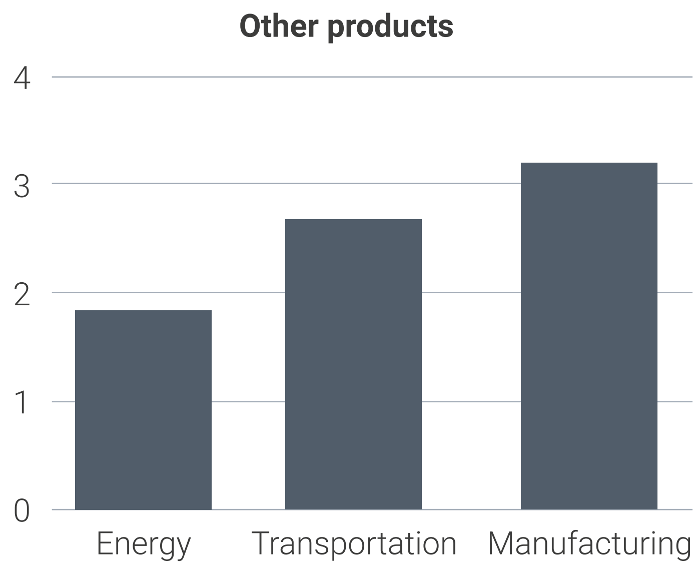
For corporate loans, the vast majority of banks have an internal taxonomy that is often used in addition to an ESRM and/or ESG framework. These types of frameworks are highly complementary and are expected to align closely with the EU Taxonomy in terms of structure and intent. The key difference with the EU Taxonomy framework lies in the increased depth and complexity of TSC requirements, which often results in higher expectations for environmental performance.

As an example, some banks note the gap between their own ESG risk-based approach and due diligence processes for environmental and social risks and the EU Taxonomy TSC and DNSH criteria. This poses the challenge of extending due diligence methodologies to align with EU Taxonomy requirements.

For corporate loans in particular, the size of the perceived gap increases when use of proceeds is not known.

Other corporate banking products - trade finance, project and export finance

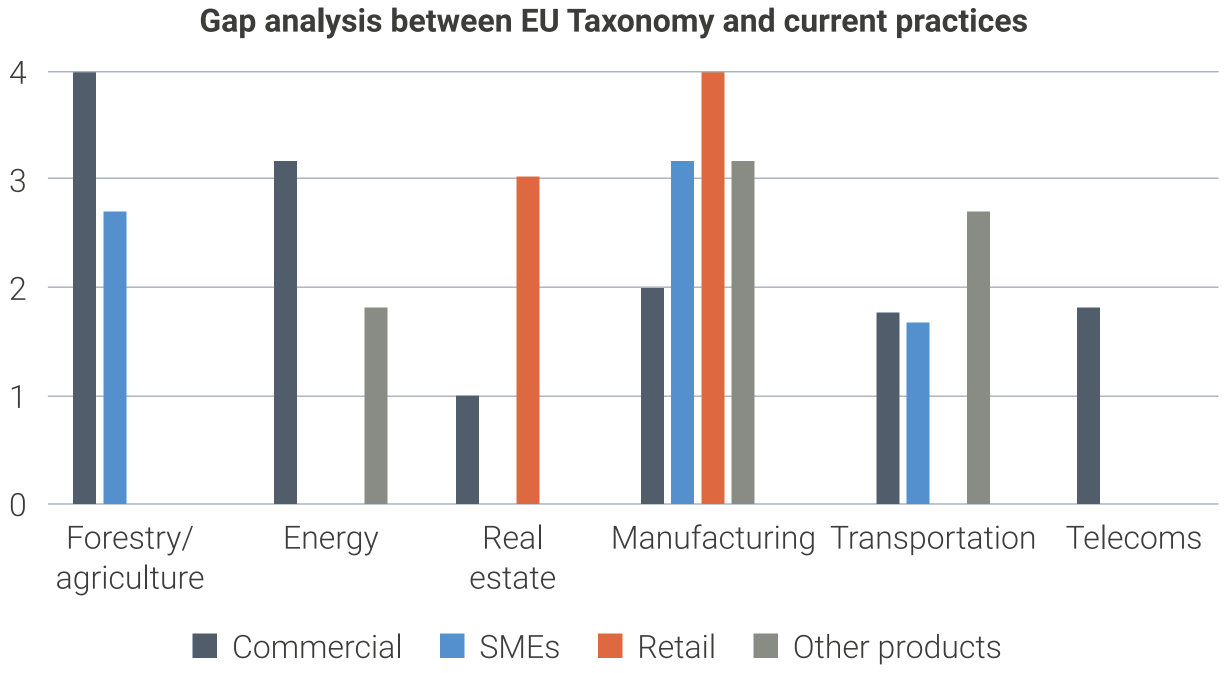
This category mainly refers to project finance, export finance and trade finance, with significant differences in the specification of use of proceeds. While project finance implies specified use of proceeds, trade finance is often unspecified.

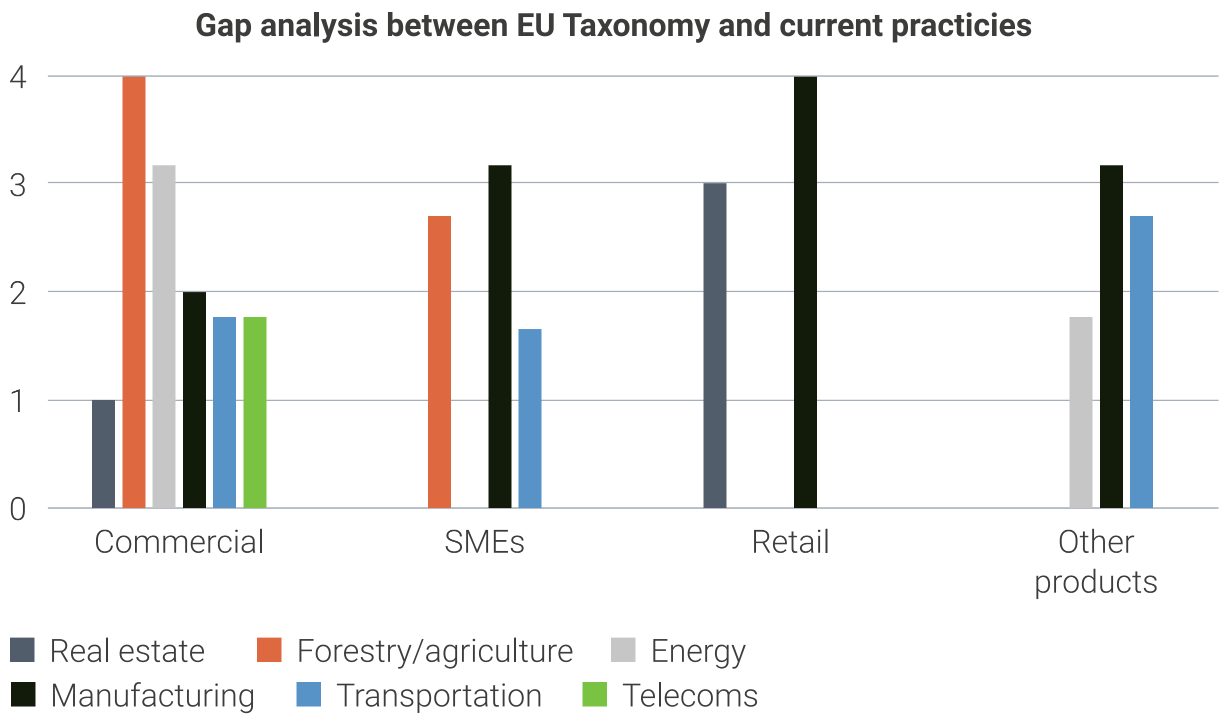


For this category of products, most of the assets were not based in the EU. This does not seem to trigger a perception that banks' existing processes are more distanced from the EU Taxonomy. This is likely due to the weight of project and export finance transactions that typically rely on the Equator Principles, IFC performance standards and OECD Common Approaches. Banks have mature and elaborate processes for these products, as well as access to ample technical documentation, all of which will facilitate their assessment against the EU Taxonomy.

Comparative views

The following diagrams provide a summary of the gaps that banks perceive between their existing processes and the EU Taxonomy.

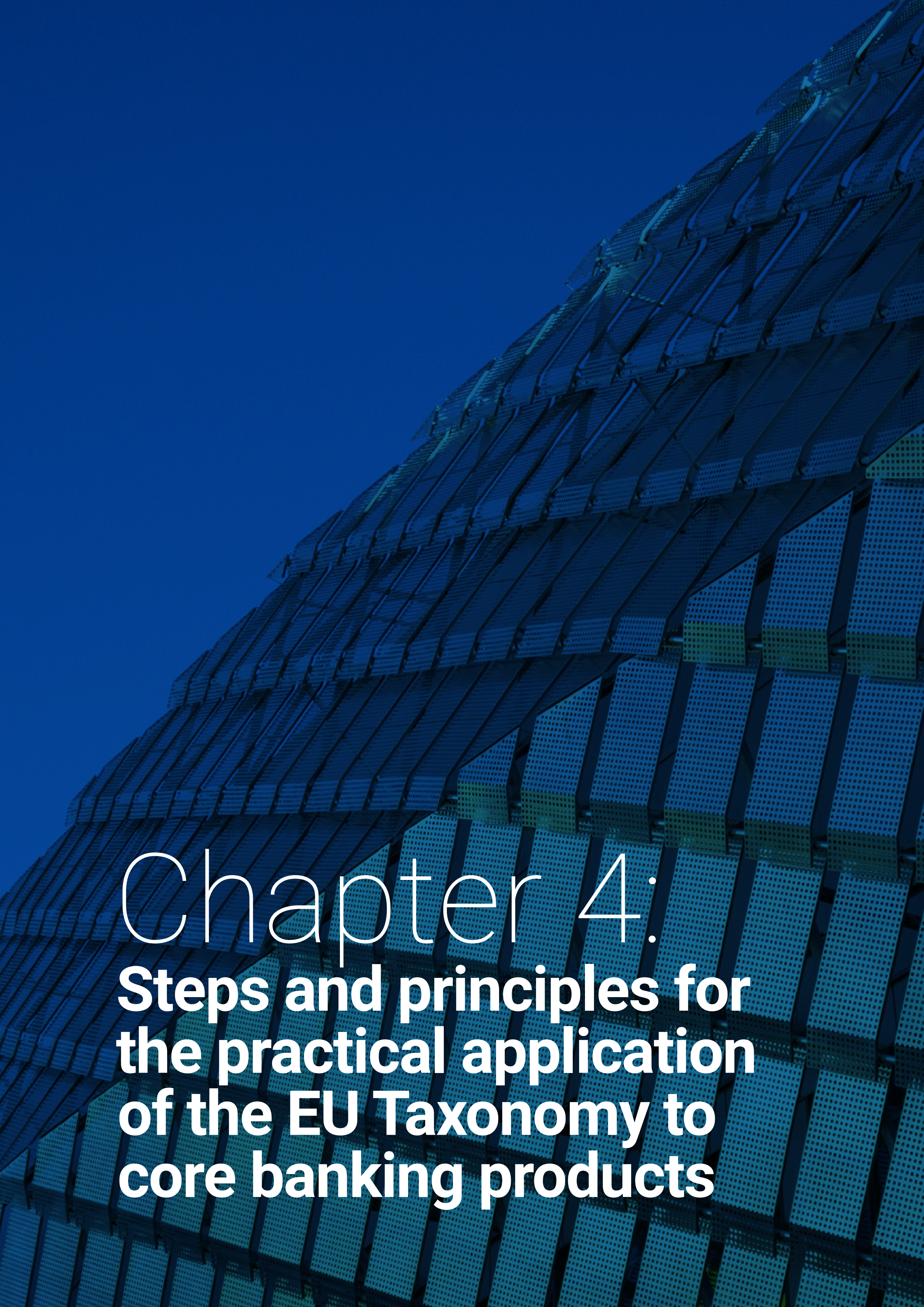




Where gaps are evident between banks' existing approaches and the EU Taxonomy, the question remains open as to how banks' business models and revenues will be impacted, and what role they may effectively be able to play in financing the climate transition and adaptation?

There may be a benefit in balancing ambitious environmental targets with the realistic ability of the banking industry to reflect them when their clients are not aligned with the EU Taxonomy. This may be particularly true when applying the EU Taxonomy to non-EU based assets. The EU Taxonomy may be in a position to lead the development of taxonomies globally if, in particular, it can provide adaptive TSC. Indeed, one non-EU based participating bank concluded that:

> **"We found that thresholds for Substantial Contribution and DNSH criteria are very granular and that there are clear gaps between the EU Taxonomy and KBFG's current requirements. KBFG's efforts to align our current practices with the EU Taxonomy will provide us with a good opportunity to improve our classification of green products, refine our ESRM policy and expand green investments and loans."**
>
> KB Financial Group (KBFG)



Chapter 4:
Steps and principles for the practical application of the EU Taxonomy to core banking products

This chapter is based on the outcomes of case studies - an experimental application of the EU Taxonomy on more than 40 real transactions, or realistic scenarios based on existing transactions.[41]

The cornerstones of the implementation of the EU Taxonomy in banking will be:

- embedding sustainability considerations in capital structuring and advisory services for clients;
- engaging with clients in order to facilitate data collection processes;
- embedding new requirements in financial products governing frameworks and their associated legal contracts; and
- ensuring that processes for loan approval and portfolio monitoring reflect and act on EU Taxonomy related requirements.

This will require significant efforts on the part of banks. Aligning to the granularity and comprehensive nature of the EU Taxonomy will be a significant challenge from an operational point of view.

The following sections outline early solutions and principles applicable across all core banking products, as well as guidance targeted specifically to selected banking product types. We present a sequence of topics that banks will typically follow internally as they perform their assessments.[42]

4.1 Overarching steps in the practical application of the EU Taxonomy[43]

4.1.1. Categorise the proceeds of a transaction

Specify use of proceeds whenever possible

A determining feature of how the EU Taxonomy will be applied to banking products is whether the lending or facility provided by a bank to a corporate is for general or specified purposes. The latter is the most straightforward way to ascertain that the funds will serve the (current) purpose prescribed by the EU Taxonomy, namely supporting climate change mitigation and/or adaptation. Specified purposes also facilitate the collection of data and the carrying out of assessments for compliance with the EU Taxonomy.

41 See overview of published case studies on page 10 of this report.
42 The structure and sequence of the assessment is typically 1. Classify 2. Assess 3. Take a view, make a decision 4. Reflect on support needed to apply the process more widely.
43 Not product specific and relevant to any type of transaction or portfolio of assets as applicable.

Step One: As far as possible **define the use of proceeds of the loan or credit facility.** Whilst it may not be sufficient in itself to align with the Taxonomy in terms of both methodology and available data, it remains the most obvious lending format to feed into the eligible activities because it will greatly reduce uncertainty.

General purpose facilities

General purpose facilities typically represent the most common form of lending and facilities provided to corporates and SMEs. **Where the use of proceeds of a transaction cannot be attributed to a specific asset or purpose, the EU Taxonomy has to be applied at the level of the company**, whether it is an SME, a mid-market company or a larger corporate. Consequently, all transactions and withdrawal authorisations towards this client, together referred to as 'gross commitment' or 'client exposure',[44] will be earmarked with the same outcome that the evaluation of the client produced.

When the client has activities across several EU Taxonomy classification types, the allocation of the overall exposure to sector(s) aligned with the EU Taxonomy becomes challenging because it is often "not possible to classify the whole client as green." **In such cases, it is proposed to split Client Exposure across activities for the purpose of classification.** For example, where a corporate draws 60% of its revenues from power generation and 40% from steel manufacturing, the gross commitment or Client Exposure will be allocated to the two sectors proportionally.[45]

Accurately classifying a client that operates across several business activities is a significant undertaking that may only be conducted for the largest exposures. Further details on the practical application of this option can be found under section 4.1.3 on corporate banking.

At this point, it is worth noting that these methods rely on assumptions that will most likely produce inconsistent results. Indeed, SMEs and corporates that use a number of banks may not be categorised in the same way from one bank to another.

This concern leads to an **emerging yet clear demand from banks that common methodologies should be developed and formally validated to ensure consistency in the application of the EU Taxonomy across the banking industry.** Further details can be found in Chapter 5 on recommendations.

Another way to overcome the issue of unspecified use of proceeds is to **ring-fence the application of the EU Taxonomy** to products and transactions with specific use of proceeds, and to **phase in the application to general purpose loans and facilities** up to the moment when corporates are required by law to report the required information under the NFRD**.**

44 Maximum amount of a credit file or the promise by a bank to lend up to a specified amount to a borrower on demand.

45 This is only an example and the percentage split will usually vary depending on the corporate's split of revenues and the exposure of the bank to the corporate.

Focusing the application of environmental and/or social restrictions on products where the use of proceeds is specified and targeted at a specific asset is the approach taken by many voluntary standards, such as the Green Loan Principles and the Equator Principles. The latter applies to financings with specified and single use of proceeds (the Project), as well as where there is majority operational control of the project by the client.

Finally, as products and transactions with unspecified use of proceeds account for the majority of transactions as far as core banking products are concerned, banks could **explore options to devise products or product features enabling better alignment with the EU Taxonomy, while maintaining the flexibility provided by the non-specification of use of proceeds.** For instance, a Revolving Credit Facility (RCF) is a very commonly used product in the unknown use of proceeds category.[46] An RCF could be split in two, with one part applicable to taxonomy alignment while the other is reserved for non-aligned or unclassified proceeds. This would also facilitate accounting for drawn versus undrawn RCFs and for how the loan has been used (green or non-green).

Step 2: When use of proceeds is not specified, choose from or consider a combination of the following options**:**

1. **Classify exposures based on the business activities of clients rather than the actual use of proceeds**, mainly for reporting purposes.
2. Consider **limiting the application of the EU Taxonomy to products where their use of proceeds is specified by the client**.[47]
3. Explore the feasibility of developing **new products which may specify use of proceeds while preserving the flexibility** provided by general purpose facilities.

4.1.2. Specify the nature of the contribution to be assessed

In the early phase of the assessment, it is essential to identify the nature of the intended or existing contribution of the transaction/funds. This helps to provide a specific focus to the assessment and minimizes the time needed to carry it out.

The EU Taxonomy offers a choice between:

- Contribution towards **Mitigation AND/OR Adaption**
- Contribution through **own performance** (which includes adapted activities) **OR as an enabling OR a transitioning activity**[48]

46 A Revolving Credit Facility is a form of credit that provides the borrower with the ability to draw down or withdraw, repay and withdraw again. Customers' outstanding balances are permitted to fluctuate based on their decisions to borrow and repay, up to an agreed limit.

47 Section 4.4 on Corporate lending proposes a potential product structure which could allow loans with unknown use of proceeds to be considered fully compliant with the EU Taxonomy. However, this idea is at a very early stage. There is a consensus that knowing the use of proceeds is the most straightforward and possibly the only way to ensure an accurate application of the EU Taxonomy in banking.

48 See Annex 1 for further details on these categories.

Not all options may be available, and often the categories which are relevant to the transaction are clearly limited to either Mitigation or Adaptation. Likewise, the nature of the contribution as own performance versus enabling activity is explicit. Nonetheless, the practical application of transactions has shown that some cases are not as straightforward, and omitting this early step may lead to an inaccurate or unsatisfactory outcome.

Let's take the example of handling machinery production as an enabling activity. While its contribution towards cement manufacturing is not recognised in the Mitigation category, it could be considered in Adaptation. Whether the enabling activity can be recognised under Adaptation will depend on securing relevant information on the company and/or targeted asset.

Finally, if the company being assessed has multiple business activities, it will be helpful to **narrow down** the economic activities that are relevant to the EU Taxonomy **at the outset of the process**. This may mean selecting client activities **based on materiality.**

Step 3: Determine into which of the aforementioned categories the transaction, activity or company fit (when the EU Taxonomy should be applied at that level). This will ensure the assessment is correctly focused and limit the number of TSC for consideration.

4.1.3. Demand data and evidence from clients

Information and data required to establish alignment with the EU Taxonomy can only be produced by clients. **Clients should therefore be responsible for supplying information and data to banks**. Current documentation requirements made by banks on clients are too limited to secure sufficient information that is relevant to the EU Taxonomy.

Whilst the quantity and granularity of information required will become clearer over time, it is already evident that banks are dependent on data from clients, and consequently will have to make more extensive data requests. Data requests will be tied to a transaction. For example, financing for renewable energy would require detailed disclosure on the origin of solar panels or wind turbines in order to assess DNSH to the circular economy objective.

Step 4: Require clients to disclose the information necessary to meet the TSC for Substantial Contribution, DNSH and MSS compliance in a format easily accessible to banks.[49]

4.1.4. Assess Substantial Contribution towards Mitigation or Adaptation

Meeting the TSC for Substantial Contribution is fundamental to achieving alignment with the EU Taxonomy. Where the TSC are not met, or where it cannot be demonstrated that they are met, the transaction and/or company cannot be assumed to be, nor reported as, compliant with the EU Taxonomy.

The sources of evidence considered suitable to support the assessment against the TSC for Substantial Contribution are:

- The company or the recipient of the funds - relevant information may be available in their public disclosures or obtained privately.
- Independent, expert studies such as Environmental Impact Assessments or an Equator Principles Independent Review. Likewise, these may be available publicly or obtained privately.

Step 5: TSC for Substantial Contribution have to be strictly met and based on evidence in order to be considered compliant. Assumption of compliance, either based on the likelihood of regulatory compliance or on assumed regulatory alignment of the regulations followed by the company/asset and the EU Taxonomy, has to be supported by evidence.

4.1.5. Assessment of Do No Significant Harm and Minimum Social Safeguards

EU based companies and assets may be presumed compliant with applicable EU legislation. As noted in Chapter 3, verification of compliance for DNSH and MSS can be arduous, particularly in a pre-NFRD enforcement context. The recurring questions when assessing both DNSH and MSS concern where to draw the line?

- What evidence can banks be reasonably expected to collect to ensure their clients comply with DNSH related TSC and MSS requirements; and
- What assumptions should banks be allowed to make about clients' compliance with applicable legislation?

This question will eventually be resolved through expected clarification on the application of the EU Taxonomy to banking products and industry guidelines,[50] which banks are widely calling for.

49 With the caveat that this step will be easier to implement once the NFRD enforces publication of information aligned with EU Taxonomy requirements.

50 See Chapter 5 on recommendations.

In the meantime, banks are relying on the following statement made by the TEG:

> **"The baseline scenario for the economic activities is compliance with relevant EU environmental legislation. To this end, the criteria take into account existing EU legislation"[51]**
>
> Technical Experts Group (TEG)

Further, as NFRD is yet to enforce EU Taxonomy disclosures on companies, banks have generally assumed that:

1. **Social and environmental regulations applicable to the company are fully aligned with EU Taxonomy requirements**[52] because national regulations are consistent with the EU legal regime - only acceptable for EU based companies and assets.
2. **The company, and the assets they operate within the EU, comply with applicable regulations unless evidence to the contrary is readily accessible[53] to banks.** Banks may feel comfortable with this assumption given that legal provisions in client contracts require them to disclose non-compliance and breaches of applicable laws and regulations, both at the time of signing and throughout the duration of the contract.

The assessment process itself follows a structured, systematic and standard format where DNSH related TSC and MSS requirements are **verified on a best effort basis.** The success of the assessment is determined by the availability of relevant information in the public domain, in internal client information records held by banks and in transaction-related documentation. Information that indicates potential non-compliance should trigger due diligence and client engagement to clarify the situation.

In some cases, banks have relied on certification schemes and labels to complete their assessment. In these cases, they have sought to identify potential gaps with the EU Taxonomy, and, where information was available, filled in the gaps through using their own.[54]

As the assessment process concludes, banks may have **to take a view on overall compliance when the outcome is ambiguous.** This typically occurs when full compliance with Substantial Contribution is fully evidenced, yet compliance with DNSH and MSS is either presumed or patchy. Banks are expecting to receive industry guidelines and further clarification from the regulator on this issue.[55]

51 EU Technical Expert Group on Sustainable Finance (2020), Taxonomy Report: Technical Annex. pp 32.

52 For the avoidance of doubt this assumption is only applicable until all regulatory requirements on corporates and SMEs are fully aligned with the EU Taxonomy, DNSH TSC and MSS requirements; it does not extend to Substantial Contribution towards Mitigation or Adaptation.

53 This refers to information available in the public domain and/or in clients' information records held by banks.

54 FSC, PEFC, EPC and NZEB were the schemes used/tested in this project.

55 See Chapter 5, recommendations 4 and 8.

Introduce timing flexibility in the assessment process

Another question is how to treat temporary non-compliance, compliance at a deferred date and verified compliance post transaction close. Transactional deadlines may not allow for the time needed to collect information that is not readily accessible to banks.[50] The availability of funding in a timely manner is often a client's key requirement and therefore a commercial differentiator.

Therefore, **flexibility regarding the time available to verify compliance should be introduced in the assessment process.** This can be achieved by decoupling the transactional and EU Taxonomy compliance deadlines. The risk associated with timing flexibility may be less leverage for banks after disbursement of funds if the company is eventually found to be non-compliant. **Banks should make a judgement on a case-by-case basis, depending on both the materiality of the issue** for which information is sought, and the client's own track record.

Step 6: In order to complete a DNSH and MSS assessment efficiently, banks can opt to:

1. **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[51] and until the NFRD enforces relevant disclosures effectively.
2. **Rely on certification schemes and labels** whilst ensuring potential gaps are filled through their own research.
3. **Proceed to transaction close and disbursement while the assessment is ongoing**, where the issues at stake are not deemed material.

It is important to note that this step is only **a potential option.** Banks may choose not to presume that their clients are compliant with applicable EU legislation. This step is specifically aimed at facilitating widespread use of the EU Taxonomy in the early stage of its implementation while its full enforcement, through regulations such as NFRD, is still to be entrenched. The reputational risk attached to such a flexible approach should be managed by banks on the basis of its materiality for each client and transaction.

4.1.6. Support needed to apply the EU Taxonomy to core banking products

In order to implement the EU Taxonomy across their products, banks will need to build on dedicated internal support and processes, as well as specific externally driven developments.

Internal support

The implementation of the EU Taxonomy will require existing functions and processes to be extended and adapted as follows:

1. **Align and engage multiple teams**. A broad buy-in from the business is a pre-requisite, and should include engagement by senior management, alongside the back office, mid-office and front office:
   - Front office support will be essential in terms of client engagement and data collection.
   - The IT function will need to upgrade internal IT systems and automate data collection and assessment as far as possible.
2. **Administration of monitoring requirements** will most likely be required together with clear delineation of roles and responsibilities between internal functions.
3. **Legal support and expertise** will need to ensure that banks' new responsibilities to its clients are adequately reflected in legal documents.
4. **Employee training** on Taxonomy-related questions and products.
5. **Environmental and/or social and industry sector specialists** should ensure banks' due diligence and monitoring are fully compliant with the EU Taxonomy.

> **"We have established a Sustainable Finance Framework, defining a global process and criteria to classify transactions and financial services as 'sustainable'. The criteria are aligned with the Green and Social Bond Principles of the ICMA as well with the EU Taxonomy, to the best of our efforts. This framework complements an existing Environmental and Social risk framework. The new framework is owned by our Group Sustainability Team, a control function that will continuously monitor the correct application of the Sustainable Finance Framework. Further, teams across all business divisions are involved in defining procedures for their respective product categories. A Group-wide Sustainability Council comprised of senior managers monitors the progress made in implementing the Sustainable Finance Framework."**
>
> Deutsche Bank

External support

External developments will also be critical in supporting the implementation of the EU Taxonomy:

1. Development of **common methodologies for banking products by relevant platforms and industry representatives**[56] that focus on:
   - the treatment of general purpose corporate loans and other products with unknown use of proceeds;
   - measuring performance against some thresholds for Substantial Contribution, such as carbon sequestration;
   - assessing performance against DNSH criteria;
   - assessing compliance with MSS.

2. The **development of suitable (or alignment of existing) certification schemes as well as verification and monitoring services** by independent experts. It is essential to specify what constitutes suitable expertise and capacity to perform these services. Indeed, some EU Taxonomy requirements demand specialised knowledge. For example, specifications for bodies providing carbon sequestration verification.

3. The provision of **implementation tools,** such as:
   - **mappings of the EU Taxonomy with commonly applied pre-existing standards,** such as national regulations which may diverge from the EU Taxonomy or IFC standards.[57] In this way, banks can narrow down data collection to what is potentially different and/or supplementary to the framework applied by the client. Mappings would be best undertaken by bodies owning the standards, and subsequently validated by relevant EU authorities.
   - **a central EU database to be set up by the European Commission** and designed to facilitate data collection and assessment, and thus avoid potentially significant and costly inefficiencies if banks were to individually conduct this process with clients having to respond to repetitive data requests.[58]

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56 See Chapter 5 for recommendations on this subject.

57 These include the Performance Standards and suite of applicable industry and EHS guidelines.

58 As proposed formally by EBF: https://www.ebf.eu/ebf-media-centre/a-centralized-register-for-esg-data-in-eujoint-letter/

4.2 Retail lending

Principles for applying the EU Taxonomy to retail lending

A number of principles have emerged from the early application of the EU Taxonomy to retail lending products:

- **Use of certification and labels:** retail lending relies on speed of execution and automated processes. Certification is well suited to assessing retail lending assets, despite the fact that, currently, certification and labels are not fully aligned with EU Taxonomy requirements.
- **Use of incentives:** a number of participant banks viewed incentives as a viable option to improve the supply of data. Incentives may be provided by sources such as banks, governments and local authorities. For example, banks could forgo management fees charged for consumer loans where retail customers provide the required data. Moreover, public authorities may consider tax incentives and subsidies, and support preferential interest rates.
- **Use of assumptions:** information and documentation available for retail mortgage loans is generally insufficient. This is unlikely to change, so documented assumptions should be considered.[59]
- **Put in place standard documentation requirements at bank level:** banks should establish minimum documentation and data requirements to be fulfilled by the client. For example, retail mortgage loan documentation processes should systematically collect Energy Performance Certificates.[60] However, as there will be costs associated to extensive obligations to register and monitor use of proceeds, particularly for retail customers, they could be applied on the basis of materiality.
- **Develop automated and database solutions at bank level:** upgrading internal IT systems needs be concurrent to the processes above to ensure that the data collected is suitably processed. This may eventually result in internal platforms collecting the data directly provided by customers when their loans are granted. This could take the form of systematic and automated surveys that collect data to inform the relevant TSC.

59 For example, Environmental Performance Certificates (EPC) for housing are not available in all EU countries. However they could be used as reference to make assumptions for real estate properties in other EU countries. Further, banks could consider an "extended reliance" on EPC certification, whereby mortgage loans labelled A or B could be eligible to be classified for Taxonomy purposes. In other words, low carbon products could be considered as directly meeting DNSH criteria for Retail. Another illustrative example is the electric vehicle sector where verifying DNSH criteria for electric vehicles made outside the EU is not possible. In this case, data base solutions should be considered, whereby car manufacturers provide details about each car available in the EU market.

60 For that purpose, EU banks contribute to the Energy efficiency Data Protocol and Portal (EeDaPP) initiative within the European Mortgage Federation, which aims to provide a Common Data Template for the Gathering, Processing and Disclosing of Data related to Energy Efficient Mortgages.

4.3 SME lending

Principles for applying the EU Taxonomy to SME banking

The early application of the EU Taxonomy to retail SME lending products found that there was a significant lack of data when assessing TSC for Substantial Contributions and DNSH. While additional engagement with and monitoring of SME clients will be necessary, it will also be costly and time consuming. This poses a substantive challenge to banks, given the industry imperative of time-efficient bank-SME relationships.

Consequently, we propose the following principles:

- For general purpose loans, **making assumptions on the share of Taxonomy aligned financing** may be necessary and should be deemed as acceptable.
- **Proxies and statistical measures** on a sector basis may be developed by banks.[61] This could also have the advantage of opening up additional lending opportunities.
- **Make use of certification schemes wherever possible, noting that there is currently no alignment between the schemes commonly used by SMEs, such as environmental quality management.**[62]

> **"The implementation [of the EU Taxonomy] will be a learning process both for banks and industry, where SMEs likely need simplified guidance".**
>
> Nordea

4.4 Commercial banking

Given the wide scope of activities and types of products embraced by commercial lending, common methodologies and solutions are not always easy to replicate. Therefore, the principles below should be taken as propositions which banks may wish to explore further.

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61 For example, in France, social entrepreneurs are developing a "Nutri-Score" for companies. This may be a very efficient way to analyse labels in order to attribute the Taxonomy Compliance label on some best mark OR propose some insertion in order to fulfil the TSC. https://www.santepubliquefrance.fr/en/nutri-score

62 This could also provide an avenue for SMEs to be educated on the EU Taxonomy by certification providers, rather than leaving it to banks. These schemes and certifiers could also serve as third party verifiers of compliance with the EU Taxonomy. For example, for forestry cases, the question arises on how to apply Taxonomy compliance on forests that are FSC/PEFC certified under an umbrella certificate, and where verification of a single forest estate every 10 years cannot be guaranteed even though certification is in place. Also, the possibility of combining FSC or PEFC certification with measurements of carbon sequestration could simplify processes.

Principles for applying the EU Taxonomy to corporate lending[63]

A number of principles have emerged from the early application of the EU Taxonomy to corporate lending products:

- Consider including **specific contractual clause(s)** in loan agreements as appropriate.[64] This may facilitate both the funding allocation to taxonomy-aligned activities and the reporting of assets aligned with the EU Taxonomy.
- Where multiple sectors are involved in a single general purpose loan, **only select the dominant and material activity(ies)**, rather than attempt to evaluate alignment across every sector. This practical approach will simultaneously reduce the burden of performing multiple assessments on a single client without compromising the intended positive impact of the EU Taxonomy.
- Where available, **rely** as far as possible **on certification schemes**. Certifications are already considered in existing Green Loans and the Green Bond Framework. However, potential limitations of some certification schemes should be accounted for in due diligence and monitoring for alignment with the EU Taxonomy.
- Depending on the materiality of the loan and/or potential for deviation from applicable regulations, consider the **involvement of an independent third party to ascertain, verify and monitor the compliance of the loan** with the EU Taxonomy.[65]
- **Where use of proceeds is not specified** and compliance with the EU Taxonomy becomes more challenging, the following options may be worth pursuing:

- **Devise new product features that enable the loan, or a well identified share of it, to be aligned with the EU Taxonomy**.

  Examples include **sustainability linked loan formats,** with Key Performance Indicators (KPIs) based on EU Taxonomy thresholds. By definition, these loans have no specified use of proceeds. When the client performs well on agreed environmental and social KPIs, there is a benefit in terms of the pricing of the loan. These new types of product features may be aligned with the Sustainability-linked Loan Principles.

  Sustainability-linked bonds and loans are particularly useful for financing first- mover companies, as well as for clients in long-run investments. The objective would be to comply with the EU Taxonomy over time (as opposed to being compliant in order to qualify).[66]

  A further option is **RCFs**[46] that can be split in two, with one part reserved for EU Taxonomy alignment, and the remainder accepted as non-aligned or unclassified. Such features would be contingent upon: 1) robust data and information provided by the

63 Corporate lending can be defined as "lending to non-financial corporations: corporations and quasi-corporations that not engaged in financial intermediation but principally in the production of market goods and non-financial services" according to the European Central Bank BSI Regulation.

64 See Recommendation 8 and Footnote 98 for early guidance on loan documentation.

65 An available option, rather than a mandatory requirement, in order to maintain the flexibility of the product, the speed of transaction execution and the cost to the borrower.

66 The climate transition requires flexibility in terms of the sustainable goals being set. Sustainability linked loans offer valuable alternatives for companies who want to include a financial link in their sustainability goals but are, for whatever reason, not willing or able to do so in a classic Green bond that complies with the EU GBS. Linking loan and bond interest rate levels to certain sustainability targets and Key Performance Indicators will definitely help companies and the entire economy transition towards more sustainable business models.

borrower, 2) annual reviews over the duration of the financing, and 3) the involvement of a third party with suitable expertise, though it is worth noting that their involvement may not be sufficient to guarantee compliance. This step, therefore, would have to be supported by substantial discussions and agreement with the client.

- **Split the loan across industry activities**.

  For example, if a corporate client draws 60% of its revenue from power generation and 40% from steel manufacturing, the loan could be allocated to both sectors in the same proportion. See the box below for further details. Unlike the option to devise a new product as mentioned above, this does not imply a specific agreement with the client and would be mainly useful for classification of a bank's portfolio according to the EU Taxonomy. This will be particularly helpful for reporting purposes.

Proposed methodology for calculating the alignment of a loan against the EU Taxonomy when the client operates across several industry sectors:

The recommended financial indicator to measure alignment with the EU Taxonomy is "Gross Commitment." It reflects the maximum amount of a credit line, in other words "the promise by a bank to lend up to a specified amount to a borrower, on demand." Gross Commitment records the amount drawn by the client in addition to the confirmed undrawn amount, excluding guarantees (i.e. drawn + undrawn, excluding guarantees).

Where use of proceeds is known, the whole value of the loan is considered in scope for the sector in which the company operates. It can be expressed as follows:

$$\textit{Dedicated } GC_{c,s,t} = \sum \textit{Dedicated } GC_{c,s,t}$$

Where use of proceeds is unknown, the loan value is allocated to sectors based on the company's activity distribution across industries. We multiplied the clients' exposure by the share of their revenue in power generation and their associated solar/wind capacity:

$$\textit{Undedicated } GC_{c,s,t} = \textit{Undedicated } GC_{c} \times \textit{Revenue share} \times \frac{\textit{Capacity}_{c,t}}{\sum \textit{Capacity}_{c}}$$

$$GC_{c,s,t} = \textit{Dedicated } GC_{c,s,t} + \textit{Undedicated } GC_{c,s,t}$$

NB: *GC* = gross commitment, *c* = counterparty, *s* = sector, *t* = technology

4.4.1. Trade finance[67]

Trade finance is the category of products that may be facing the highest level of limitations when applying the EU Taxonomy due to a combination of any of the following aspects:

- Absence of a direct link to either the buyer or seller, meaning banks have particularly low leverage when obtaining information on the underlying object of the trade;
- One of the parties is based outside the EU;[68]
- One of the parties is an SME;[69]
- A low value transaction that implies limited available funds to support ad-hoc research and investigation to obtain data; and
- Fast-paced, partially automated and short transaction cycles.

In this context, the following principles have emerged for the application of the EU Taxonomy to trade finance:

- Banks may **consider upfront whether, or which type(s) of, trade finance transactions should be eligible** to the EU Taxonomy on the basis of 1) the level of difficulty and associated costs to make an assessment[70] and 2) whether the transaction will be an asset on the bank's balance sheet - for example, guarantees are not typical lending assets recorded on the bank's balance sheet.

Where the bank determines that trade finance products may be eligible, the following options are available:

- Banks may **rely on metrics and data available at country and industry level as proxies** for transaction specific data. For example, banks may combine relevant data for industry sectors or commodities, countries of origin and associated energy mix, modes of transport, certifications, etc. to evaluate alignment with the EU Taxonomy.[71]
- Where feasible, and depending on transaction value and time, the **bank's client should facilitate/broker access to relevant information on the other party,** when required. For example, where a guarantee or a supply chain finance loan are provided by the bank to a buyer who also has an existing relationship with the bank, they should request relevant information from the seller and provide it to the bank. However, it should be noted that information collection flows will be difficult to implement within the time available to complete most trade finance transactions.
- The assessment of **DNSH to adaptation and the evaluation of eligibility as an activity enabling adaptation** will **require information to be collected on the end use of the products and services, as well as potentially the means and duration of the transport of goods** being financed.

67 Trade finance refers to financial instruments and products that are used by companies to facilitate international trade and commerce. Trade finance makes it possible, and easier, for importers and exporters to transact business through trade. Trade finance always links lending to the trade cycle of a business and always involves several parties, typically a buyer and a seller where only one of those has an existing client relationship with the bank.

68 See challenges related to non-EU based assets.

69 See challenges related to SMEs.

70 Based on criteria mentioned above.

71 This approach requires the development of a methodology and mapping tool readily available to support fast-paced transaction flows, rather than being an ad-hoc approach for individual transactions.

- When these options are not available and:
  - the minimum information required for assessing Substantial Contribution for EU based trade is not available; and
  - the minimum information required for assessing Substantial Contribution, DNSH and MSS for trade transactions involving a material non-EU based party is not available

  then the transaction should not be considered eligible.

4.4.2. Project and export finance[72]

Project and export finance transactions fall in the category of products where applying the EU Taxonomy is straightforward. This is because they typically have a higher value and a long transactional cycle. In addition, due to heightened risk implied by non-recourse finance, they are typically supported by a number of technical environmental and social documents, including those leading to legal permitting and independent expert reports.[73] Indeed, project and export finance transactions are accompanied by an unusually high level of environmental and social information, often verified by independent experts, circumstances ideally suited to assessing alignment with the EU Taxonomy.

Based on an initial application of the EU Taxonomy to such transactions, the following principles are proposed for projects where the EU Taxonomy may be applicable:

- **Whether providing advisory, arranging or lending services, the bank should inform the client as early as possible** of the need to assess alignment of the project with the EU Taxonomy, to the extend relevant and feasible. This will facilitate the subsequent due diligence process and can significantly increase the possibility of full alignment with the EU Taxonomy.
- Where the loans are intended to be earmarked for EU Taxonomy aligned financing, the **bank may require EU Taxonomy alignment to be formally committed to by the client in relevant legal documentation.** This may take a different form, such as a covenant or event of default, depending on the level of materiality involved. However, inclusion in the legal documentation is not essential for the financing to be considered aligned with the EU Taxonomy.
- **The terms of reference for any third party expert** supporting the client and/or the bank in the application of environmental and social standards **should include the EU Taxonomy** among the applicable standards. This will ensure that environmental and social technical reports used by banks in their due diligence provide a clear and reliable assessment of the project against the EU Taxonomy.
- Banks must take **appropriate measures for ongoing compliance with the EU Taxonomy over the duration of the financing and, where applicable, through to the project's operational phase.** Similar to the application of environmental and social standards

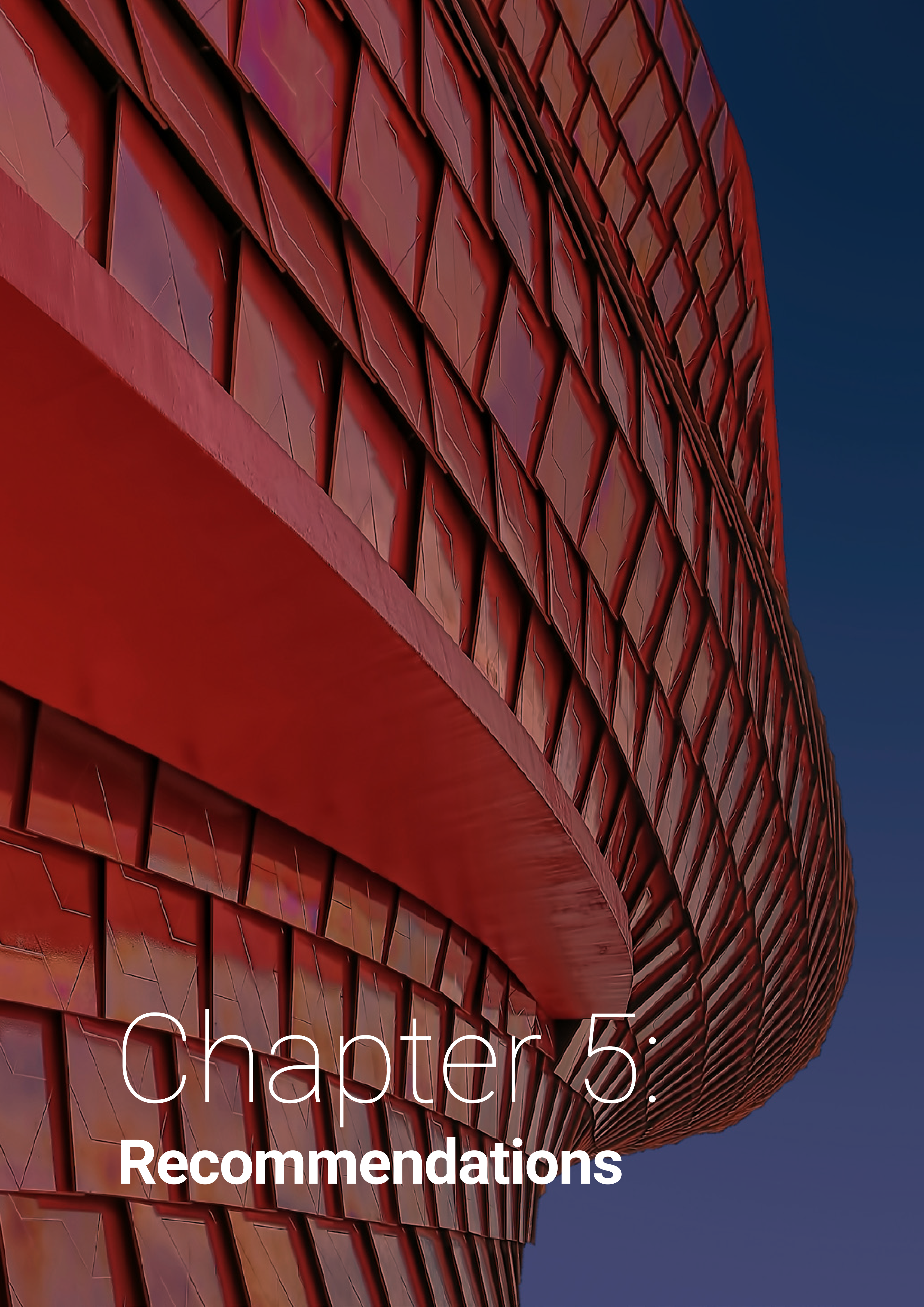
72 Export finance is the provision of dedicated funding and insurance products that reduce the risks of selling goods and services internationally. Project finance is the funding (financing) of long-term infrastructure, industrial projects and public services using a non-recourse or limited recourse financial structure.

73 For EU based banks, reports will commonly assess alignment with the Equator Principles and underlying IFC standards, and/or with OECD Common Approaches.

specific to this category of products,[74] some EU Taxonomy requirements may be met over time. Banks must demand ongoing compliance from the project's developer, past disbursement and reassess compliance regularly. This implies that ongoing environmental and social management of the project[75] during all different stages, through to operations, must embed the requirement of the EU Taxonomy. **Banks must take appropriate measures to monitor ongoing compliance as appropriate.**

It should be noted that these principles are fully aligned with existing practices of banks that are signatories to the Equator Principles, and also with those that follow the OECD Common Approaches.

74 Typically the Equator Principles and underlying IFC standards, and/or OECD Common Approaches
75 This will often materialise as an Environmental and Social Management Plan (ESMP)



Chapter 5: **Recommendations**

A set of recommendations has been put forward by banks participating in this project, based on an experimental application of the EU Taxonomy to banking products. These recommendations are targeted at legislators and regulators, industry standard owners and banks themselves.

Audience	Recommendations
Legislators and regulators should	
Recommendation 1	Take into account the **specificities of core banking products** which may limit a full application of the EU Taxonomy.
Recommendation 2	Ensure **consistency and compatibility/comparability of criteria** between the EU Taxonomy and other applicable legislation and regulations, including at national level.
Recommendation 3	Seek **global alignment of taxonomies**, facilitate international data collection and provide comparability mechanisms of criteria for **applicability of the EU Taxonomy beyond EU borders**.
Recommendation 4	Consider and seek **to address the timing mismatch** between corporate data availability and banks' ability to apply and disclose against the EU Taxonomy.
Recommendation 5	Facilitate the collection and **handling of data**, through the **development of tools** to facilitate the application of the EU Taxonomy.
Owners of standards and frameworks, labels and certification schemes should	
Recommendation 6	**Clarify alignment** with the EU Taxonomy.
Banks should	
Recommendation 7	Start **methodical data collection** for taxonomy-relevant information **as part of new origination**, on a best effort basis, based on internal strategy and priorities.
Recommendation 8	Devise **industry guidelines** for the implementation and application of the EU Taxonomy to core banking products, in conjunction with relevant industry bodies.

Recommendation 1: Legislators and regulators should take into account the specificities of core banking products that may limit a full application of the EU Taxonomy.

As demonstrated in Chapter 3**, some challenges are specific to the nature of core banking products and the operational processes that support them, such as products and transactions where the use of proceeds is not specified, and the diversity of banks' customer bases.** An indiscriminate treatment of financial products may lead to a disadvantage for the lending side compared to the investing side. This is because the investing side can calculate the part of the equity that will be invested, whereas the lending side is limited by the unspecified use of proceeds of general corporate loans.

It is important to appreciate the extent to which many of the banks' financial services are not in the capital markets space, notably their financing of households and small businesses, both critical parts of the economy.

Consequently, there is a case for acknowledging that banking and investment activities are distinct, and to therefore **tailor an approach to applying the EU Taxonomy suited to the specificities of core banking products and activities.**

Recommendation 8 provides further details on a proposed approach for this aspect.

Recommendation 2: Legislators and regulators should ensure consistency and compatibility/comparability of criteria between the EU Taxonomy and other applicable legislation and regulations, including at national level.

Legislators and regulators should:

- Ensure **consistent transposition of relevant EU Directives at national level** to secure the application of Substantial Contribution criteria.[76] That includes, where possible, **streamlining the approach to TSC** for Substantial Contribution and DNSH where connections with local regulations and reliance on local statistics make the application of the EU Taxonomy challenging.[77]
- Ensure that **DNSH and MSS criteria are consistently reflected across all relevant laws governing the reporting of corporates and SMEs, in such a way that alignment with DNSH TSC can be expected for EU based companies and assets.**
- **Make the NFRD a Regulation rather than a Directive** in order to enhance comparability and applicability across the EU, thereby limiting potential national interpretations and subsequent inconsistent implementation.[78]

76 For example, there is no consistent national definition of Net Zero Energy Buildings requirements embedded in the Energy Performance Buildings Directive.

77 As identified by a number of case studies which are inconclusive or cannot confirm alignment with the EU Taxonomy.

78 EU Regulations are directly applicable in Member States whereas Directives require transposing into national law.

Recommendation 3: Legislators and regulators should seek global alignment of taxonomies, facilitate international data collection and provide comparability mechanisms of criteria for applicability of the EU Taxonomy beyond EU borders.

For the purpose of facilitating trade flows and economic development, banks also recommend legislators and regulators consider **international alignment of existing national and regional taxonomies,**[79] **including the EU Taxonomy**, notably via the International Platform for Sustainable Finance.

Bank lending is also a key financing method for EU banks with activities outside the EU. This prompts the question **of non-EU based assets and companies** facing challenges with data collection, due to the fact that local and national applicable regulatory framework(s) do not require the publication of data, should assess alignment with the EU Taxonomy. In these cases the application can only be made on a best effort basis.

Banks recommend that legislators and regulators **provide further clarity on possible comparability mechanisms, tools to improve data availability and the scope of application given operational limitations.**

Recommendations 6 and 8 provide further details on a proposed approach for this aspect.

Recommendation 4: Legislators and regulators should consider and seek to address the timing mismatch between corporate data availability and banks' ability to apply and disclose against the EU Taxonomy.

As demonstrated in chapter 3, the availability of data is the single biggest challenge identified in the early application of the EU Taxonomy.

For companies based and regulated within the EU, this is largely attributed to the fact that taxonomy-linked NFRD reporting requirements are not yet applicable.[80] EU Taxonomy data requests (particularly in terms of TSC) should be aligned to information that must be disclosed within the framework of Non-Financial Reporting.

79 This refers to taxonomies that are already available, such as the NDRC Green Industry Guiding Catalogue and the PBC Green Bond Endorsed Project Catalogue issued in China. Together they are considered to form the equivalent of a green taxonomy. It also refers to green taxonomies in development worldwide, in Canada, South Africa, Japan and Malaysia, among others.

80 As seen in Chapter 1 and Annex 1, companies within the scope of the NFRD are not due to publish data until 2022 and further revision including an extension of the scope of the NFRD is still pending.

However, disclosures by financial market participants for products within the scope of the mandatory application of the EU Taxonomy are expected to start in 2021.[81] Banks disclosures will depend on the ability and willingness of third parties to provide data, as banks cannot be expected to be a channel for regulatory enforcement. During the interim period, banks will aim to disclose against the EU Taxonomy on a best effort basis, given their dependency on information provided by their clients.[82]

Finally, regulators and legislators may consider incentivising the provision of data[83] by corporates and SMEs.[84] Incentives tied to the use of the EU Taxonomy can substantially boost its adoption by corporates, SMEs and financial market participants.

Recommendation 5: Legislators and regulators should facilitate the collection and handling of data, through the development of tools to facilitate the application of the EU Taxonomy.

The experimental application of the EU Taxonomy has shown that assessments can be repetitive and duplicate participants' efforts. This points to potentially significant inefficiencies in the use of banks' resources, particularly when assessing for DNSH and MSS criteria. **Developing and/or sponsoring tools** which support the direct and concrete application of the EU Taxonomy is an **essential step towards industry-wide application.**

Tools and solutions fall broadly within the following categories:

- A centralised electronic register for ESG data in the EU, collecting and storing information in accordance with the NFRD and the EU Taxonomy, as well as other ESG data for financial market participants to comply with the SFDR,[85] Taxonomy Regulation, Pillar 3 requirements and other relevant regulatory or non-regulatory requirements where banks are dependent on external data.
- Further database type solutions for compiling data submitted by companies directly. Proposals include centralising the Energy Performance Certificates in a public EU data centre,[86] a CO_2 emissions database at EU level categorised by business activity and product (by vehicle, home appliance, etc.), and utilising machine learning and satellite data to track carbon sequestration of forestry investments. All of these should be designed to facilitate data collection and assessments, and thus avoid potential costly

81 See Chapter 1 Legislative process, current status and milestones for the legislation.

82 This also implies a provision to impose less stringent requirements on existing portfolios, in particular the general purpose facilities component of banks' portfolios.

83 Where relevant incentives will also be needed for the application of monitoring procedures and independent verification.

84 Banks have stressed the need for incentives for SMEs to establish an interest in applying the Taxonomy. This can take the form of a guidance hub offering practical advice to SMEs on the implementation and interpretation process around the Taxonomy, and for sharing knowledge.

85 This has been proposed formally by the EBF: https://www.ebf.eu/ebf-media-centre/a-centralized-register-for-esg-data-in-eujoint-letter/

86 Today, EPCs are centralized by public authorities in some countries (Spain, Netherlands, three regional governments in Belgium) but not all. Today EPCs are centralized by public authorities in some countries (Spain, Netherlands, three regional governments in Belgium) but not all. A solution would be to extend the Central Repositories of certificates (including vehicle certificates and characteristics) to all EU countries, and allow banks to integrate the information in their systems."

inefficiencies if banks were to conduct the same processes individually, resulting in clients having to respond to significant numbers of repetitive data requests.

- Common digital platforms to facilitate calculations and modelling for transactions and portfolios to be applied consistently.
- An interactive and easily accessible channel of communication with the EU Platform for Sustainable Finance, an "EU Taxonomy Q&A", to provide clarifications on an ongoing basis. This should foster a consistent application of the EU Taxonomy across the finance industry.

Recommendation 6: Owners of standards and frameworks, labels and certification schemes should clarify alignment with the EU Taxonomy.

Mapping the EU Taxonomy with pre-existing frameworks commonly used by the industry is one of the most common suggestions among the group of banks that trialled the application of the EU Taxonomy. Mapping standards with the EU Taxonomy involves associating each element of a given standard with one or more elements of the EU Taxonomy.

The market standards that banks see as a priority for mapping with the EU Taxonomy are:

- The Green Bond Principles issued by the ICMA[87]
- The Green Loan Principles from the LMA[87]
- The LMA Sustainability-Linked Loan Principles[88]
- The Equator Principles, and the IFC performance standards and set of guidelines that are commonly used as reference for managing environmental and social risks associated to some types of financial products, such as project finance.[89]
- The OECD Common Approaches applied by Export Credit Agencies - therefore particularly important for export finance transactions.
- Environment-related labels, and green labels on financial products as listed in chapter 1

87 Both ICMA and LMA approaches focus on use of proceeds. However, the Green Bond Principles scrutinise parameters such as governance, control of use of proceeds and reporting on impact. Meanwhile, the Taxonomy focuses on TSC to assess environmental performance. Principles issued by ICMA and LMA often require validation by external consultants. The development of common taxonomy-compliant loan formats that may be incorporated into the Green Loan Principles and, if feasible, into the Sustainability-Linked Loan Principles, would give visibility and transparency to market players and facilitate reporting requirements.

88 Developing a specific EU framework for Sustainability-Linked loans to apply the EU Taxonomy may be required to facilitate applicability. This is regarded as a key step for the development of Transition Lending as, in 2019, Sustainability-Linked Loans represented 80% of the global volume of Green and Sustainable syndicated loans to corporates vs. only 20% for Green Loans or known use of proceeds lending. However, while it is possible to link a standard to the EU Taxonomy, whenever feasible, room should be left for set-ups that cannot (yet) be clearly covered by the standard. Currently, the negotiated rates for these products vary according to targets that are much broader than the scope of the EU Taxonomy, so it is not possible for a standard to set targets using the EU taxonomy; extract from https://www.ebf.eu/wp-content/uploads/2020/07/EBF-key-messages-Renewed-Sustainable-Finance-Strategy.pdf

89 The IFC Performance Standards take a higher level approach higher level than the EU Taxonomy. Guidelines associated to the IFC performance standards can sometimes be more qualitative and subjective. For example, criteria on water, circular economy and pollution have been reported by some banks as "much broader". The room for interpretation that comes with the IFC performance standards makes it difficult not only to perform the assessment, but also to establish alignment with the EU Taxonomy.

- Industry specific certification schemes: For example, FSC[90] and PEFC[91] certification schemes which are widely used by banks that finance forestry assets as evidence of compliance with their environmental and social screening criteria.[92]
- NACE to ISIC and national classification schemes: Some banks use ISIC[93] for internal classification of activities rather than NACE. The EU Taxonomy is based on NACE.
- Environmental Goods and Services Accounts of EU member states.

While this is not an exhaustive list, it covers the majority of commonly applied standards and frameworks.[94] Mapping the EU Taxonomy to them will go a long way in advancing the adoption of the EU Taxonomy among EU banks, and greatly facilitate its use by non-EU regulated banks.

Recommendation 7: Banks are encouraged to start methodical data collection for taxonomy-relevant information as part of new origination, on a best effort basis, based on internal strategy and priorities.

While clients are not yet legally obliged to provide all necessary data, collection processes can be set up ahead of regulatory enforcement. The fulfilment of data requests may remain voluntary up until this point.

This **could benefit relationships with clients** who may value foreknowledge and the opportunity to gain an early understanding of how the EU Taxonomy Regulation may impact their access to financing.

Banks will benefit from a **smoother**, and likely cheaper, **implementation** process. Early-movers may gain a **competitive advantage** through developing a sharper commercial lens ahead of regulatory enforcement.

Finally, the **development of common templates for data collection** could significantly improve the efficiency with which information is acquired, while streamlining reporting.

Recommendation 8 provides further details on a proposed approach for this aspect.

90 Forestry Stewardship Council.
91 Programme for the Endorsement of Forest Certification.
92 Relevant authorities still have to formally acknowledge each certification and label scheme as valid markers of compliance with the EU Taxonomy for each of the corresponding economic activity(ies).
93 The International Standard Industrial Classification of All Economic Activities, maintained by the United Nations Statistics Division.
94 Some standards may be issued subsequently to this report and may be considered highly relevant.

Recommendation 8: Banks and relevant industry bodies should devise industry guidelines for the implementation and application of the EU Taxonomy to core banking products.

Risks and adverse impacts of potential inconsistencies **are most likely to emerge where methodologies and proxies need to be developed.** This is typically where data is unavailable, where the EU Taxonomy requires interpretation for its application and where the framework needs to be adapted to become applicable to unforeseen scenarios and financial products.

Inconsistencies in the application of the EU Taxonomy within the banking industry could set back both the purpose and industry-wide benefits of its adoption, including fostering comparability. Common methodologies can **ensure comparability of data and essential transparency in terms of assumptions and calculations.**

Chapter 4 provides a high-level set of principles for the application and implementation of the EU Taxonomy. Yet this is only a first step, and **banks should devise more detailed industry guidelines** on the implementation and application of the EU Taxonomy.

Issues to cover in such guidelines are many and varied. The following list of guidelines is not exhaustive, while issues and themes will overlap to some extent:

A. **Guidelines on the application of the EU Taxonomy to specific product types, the development of new products and the provision of advisory services**, including:

- Application to general purpose loans and corporate loans
- Application to SMEs[95] and retail products
- Green Loans and Green Bonds
- Embedding the EU Taxonomy in new product development, capital structuring and advisory services[96]
- Applying the EU Taxonomy to non-EU based assets[97]

Guidelines should ideally comprise concrete implementation tools such as standard templates ready for use by banks. They should cover key aspects of the transactional cycle, such as provisions and guidance for preparing legal documentation.[98]

95 This could be for overall business relations with SMEs. Banks have also stressed the need for simplified procedures for small operators. Guidance should be location specific and is required for the application of principles and TSCs in the specific context of SMEs. For example, to identify where to use statistical assumptions, provided by national statistical agencies, on a sectoral or regional level, and to identify where to make use of proceeds assumptions. Finally, where SMEs have to rely on existing certification schemes, new taxonomy-related information may simplify the process and provide reliable third party verification.

96 Embedding sustainability requirements in capital structuring and client advisory services, so that capital structures optimally reflect clients' sustainability ambitions and activities.

97 Frameworks for due diligence processes and monitoring.

98 Market standard templates for legal provisions will promote consistency while permitting flexibility. For example, the Green Loan Principles, together with the APLMA and the LSTA, have been broadly adopted as a market reference point in the preparation of green loan lending documentation. These principles could be further extended into proposed market standard template provisions for key clauses that are typically required by the Principles for both green and sustainability linked loans. The Green Loan Starter Pack is helpful in this respect.

B. **Methodologies for the application of specific requirements in the EU Taxonomy**:

- Segmenting alignment by eligible activities using client turnover, revenues, capex and opex
- Due diligence, assessment structures and acceptable assumptions towards DNSH and MSS [99]
- Modelling, when data is not available or proceeds are not known[100]
- Benefits and requirements in using third party verification[101]
- Conditions for use of, and reliance on, certification schemes

C. **Reporting Guidelines** including voluntary standard templates for disclosure of portfolio alignment with the EU Taxonomy in order to promote rigour, consistency and comparability within the industry.[102]

D. **Guidance and lessons learned on the integration of the EU Taxonomy into banking processes,** including:

- Application at transactional level
- Application at portfolio level
- IT processes and infrastructures

It is advisable that some of the guidelines produced are **formally recognised by, and developed in collaboration with, relevant authorities/regulators** to foster their consistent use throughout the banking industry.

99 For EU based operations covered by EU level environmental and social legislation, are compliance assumptions acceptable or does DNSH and MSS verification have to be comprehensive, systematic and on a transactional basis? For example, what level of granularity and evidence of compliance when applying the OECD due diligence model is necessary? Can other banks' existing processes be deemed sufficient? Can the assessment rely fully on, and limit itself to, the EPC for retail credit transactions, such as retail mortgages in the EU? And so forth.

100 Modelling and statistical assumptions can assist in performing the analysis at portfolio level when data is not readily available. A common methodology would ensure comparability of data.

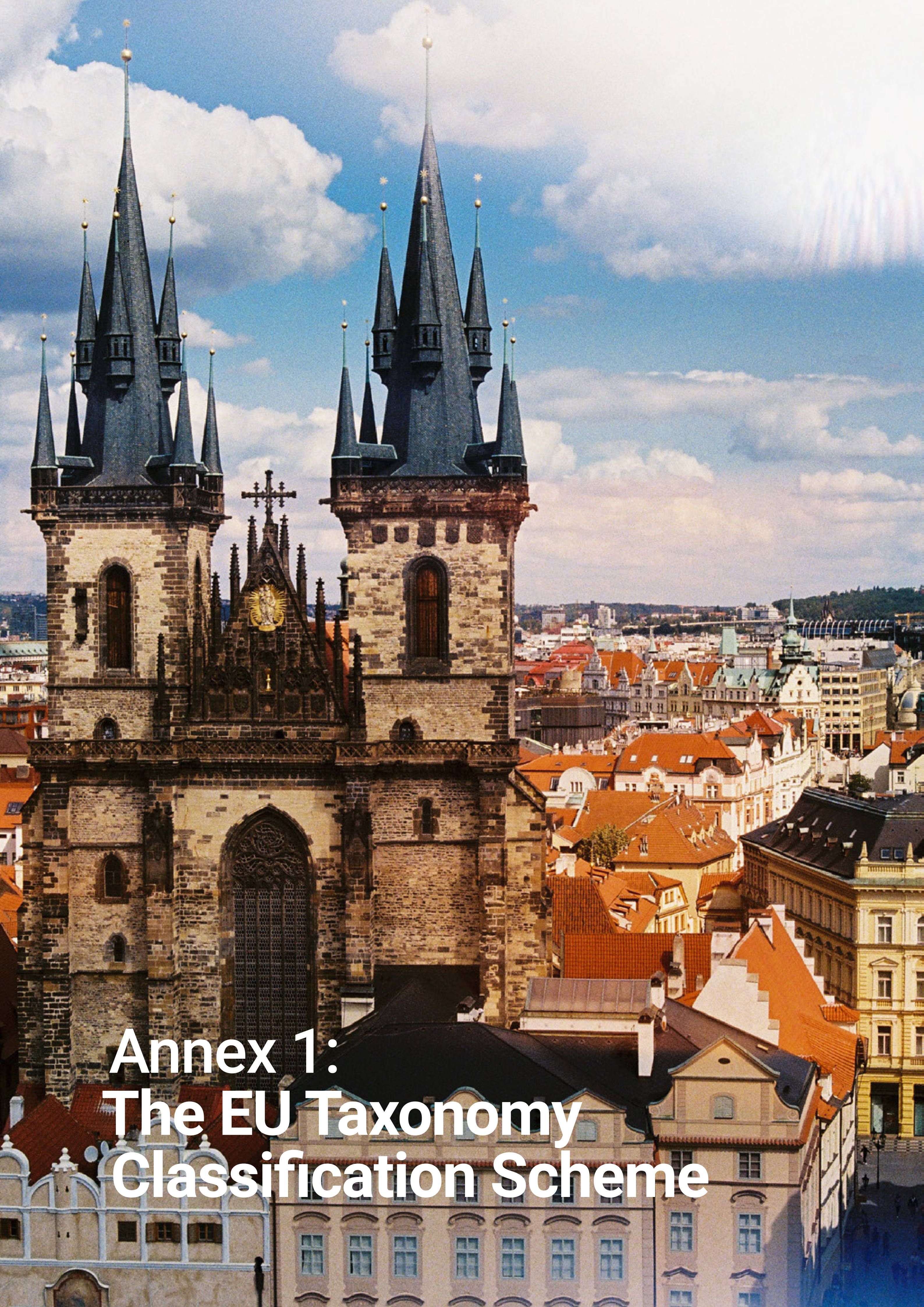
101 Without clear guidance as to when and how to verify compliance with the EU Taxonomy, only some transactions and portfolios would be verified by third parties, which is likely lead to inconsistent application of the EU Taxonomy and challenges over comparability of portfolios.

102 These may be included in annual reports. Standard templates could be product-based and include specific criteria to assess each transaction, identifying levels of alignment with the EU Taxonomy depending on the quality of the available data and the main assumptions considered. They could be used for disclosure purposes and ensure better comparability amongst banks that share a common set of criteria and assumptions.

Closing Remarks

The objective of this report was to develop an initial and practical understanding of the applicability of the EU Taxonomy to banking products and propose a set of recommendations to enhance applicability. The context of this project was the upcoming enforcement of the EU Taxonomy Regulation and the ongoing revision of the NFRD.

This first step has been completed successfully. Banks will now focus on devising guidelines and methodologies as well as engaging with the Sustainable Finance Platform and other stakeholders to support the delivery of the recommendations contained in this report.



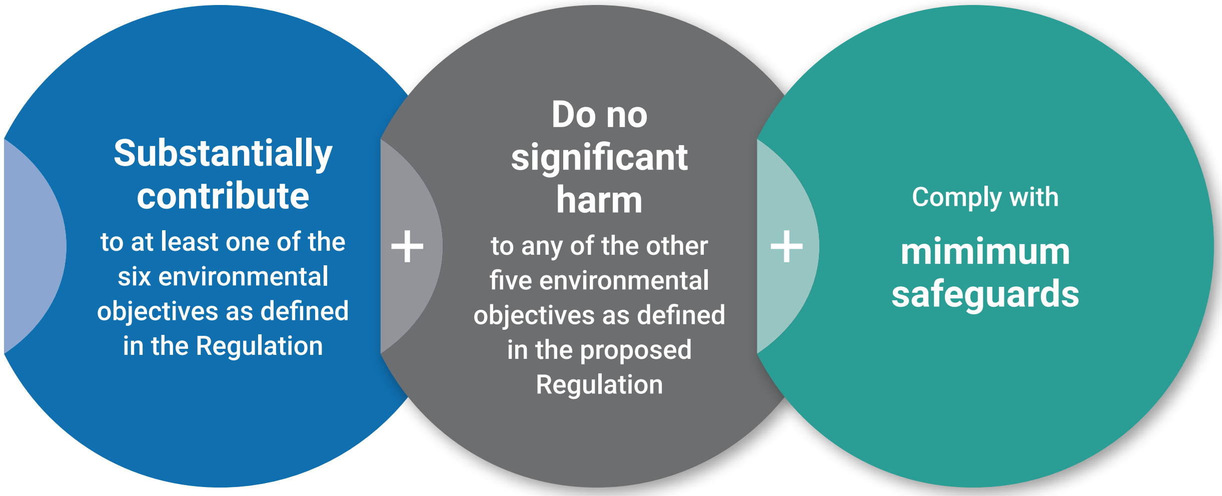
Annex 1: The EU Taxonomy Classification Scheme

The current focus of the EU Taxonomy regulation is on classifying relevant activities into two fundamental categories: climate change mitigation (Mitigation) and climate change adaptation (Adaptation).

In order to perform the classification, EU Taxonomy users are expected to follow the framework provided by the regulation. In its current form, the framework helps the assessment to demonstrate that the economic activity under consideration:

1. Contributes substantially towards either Mitigation or Adaptation;
2. Does not harm the environment in other ways; and
3. Meets minimum social standards referred to as "Minimum Social Safeguards" (MSS).

The concept is illustrated in the TEG final technical report as follows:



In order to demonstrate that an economic activity aligns with the EU Taxonomy, users need to undertake an assessment against the key components of the framework:

- a set of **six environmental objectives**
- **four** performance **requirements**
- three types of **Technical Screening Criteria** (TSC)

Six Environmental Objectives	Four requirements	Three Types of TSC
▪ Climate change mitigation[103] ▪ Climate change adaptation ▪ Sustainable use and protection of water and marine resources ▪ Transition to a circular economy, waste prevention and recycling ▪ Pollution prevention and control ▪ Protection of healthy ecosystems	▪ Comply with the TSC ▪ Contribute substantially to one or more of the environmental objectives ▪ Do not cause significant harm to any of the remaining environmental objectives ▪ Comply with minimum safeguards (such as adherence to international social and business standards and conventions)	▪ Help to evaluate: ▪ Substantial Contribution to Mitigation ▪ Sustainable Contribution to Adaptation ▪ Do No Significant Harm (DNSH)

There are distinct parts to the evaluation process:

i. Evaluation of Substantial Contribution
ii. No Significant Harm assessment
iii. Compliance with MSS
iv. Segmenting in terms of turnover, capital expenditure (capex) and operational expenditure (opex)

i. Evaluation of "Substantial Contribution" towards either Mitigation or Adaptation

In order to determine whether an economic activity is eligible, the participant needs to evaluate whether the activity **contributes substantially** to the mitigation of, or adaptation to, climate change. What is considered substantial is determined by the TSC for Mitigation and the TSC for Adaptation.

The **TSC for Mitigation** define Substantial Contribution as the stabilisation and reduction of greenhouse gas concentrations in the atmosphere, to a level that prevents dangerous anthropogenic interference with the climate system. Meanwhile, the **TSC for Adaptation** seeks to identify substantial reduction of the adverse impact of climate change, or risk of adverse impact, on the economic activity under consideration.

The two separate sets of criteria reflect the fundamental differences between climate change adaptation activities and mitigation activities: "for Mitigation activities, a one tonne reduction of CO2 emissions has the same impact, regardless of where the Mitigation activity takes place", whereas "Adaptation responds to physical climate risks that are mostly location and context specific".[104]

The EU Taxonomy recognises two distinct types of Substantial Contribution applicable across Mitigation and Adaptation, and an additional type only relevant to Mitigation. These **different types of Substantial Contribution** are reflected in the TSC:

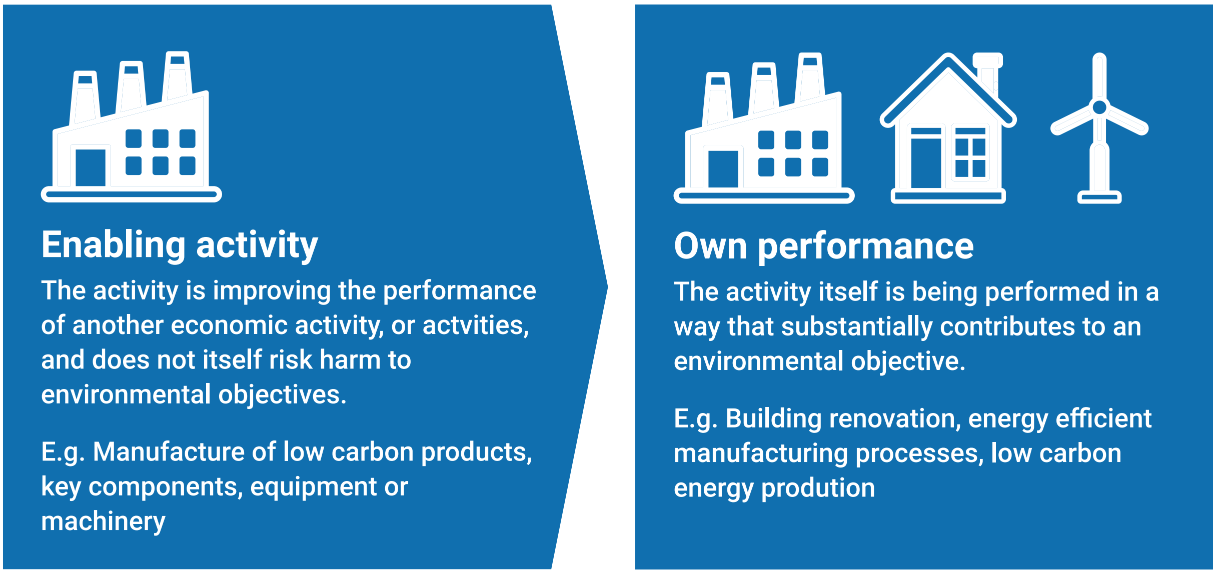
103 Note that climate change mitigation and adaptation objectives are both environmental objectives.
104 EU Technical Expert Group on Sustainable Finance (2020), Technical Annex, p.19

i. Economic activities that make a Substantial Contribution based on their own performance: For example, power generation from renewable energy sources or a steel production company meeting or exceeding the required technical criteria.

ii. Enabling activities: Economic activities that, through provision of their products or services, enable a Substantial Contribution to be made in other activities. For example, a building management company that installs efficient boilers or a wind turbine manufacturer.

iii. Transition activities: This third type of Substantial Contribution is only applicable to Mitigation. These are activities that contribute to a transition to a net-zero emissions economy by 2050, but are not currently close to this level. These activities must significantly enhance their performance. The TSC for these activities will be revised on an ongoing basis to reflect the different requirements to achieve zero carbon emissions over time.

The figure below illustrates the relationship of enabling activities to those activities that are substantially contributing based on their own performance.[105]



ii. DNSH Assessment

An economic activity that makes a Substantial Contribution to Mitigation or Adaptation must also be assessed to ensure it **does not cause significant harm** to any remaining environmental objectives. For example, an activity contributing substantially to climate change Mitigation must not do significant harm to climate change Adaptation or to the other four environmental objectives, listed here:

- Sustainable use and protection of water and marine resources
- Transition to a circular economy, waste prevention and recycling
- Pollution prevention and control
- Protection of healthy ecosystems[106]

105 EU Technical Expert Group on Sustainable Finance (2020), Technical Report, p.15

106 EU Technical Expert Group on Sustainable Finance (2020), Technical Annex, p.29

TSC for DNSH can be a combination of quantitative, process-based, qualitative and principles-based criteria. For environmental objectives not related to climate change, the DNSH TSC are primarily defined by EU environmental regulations.

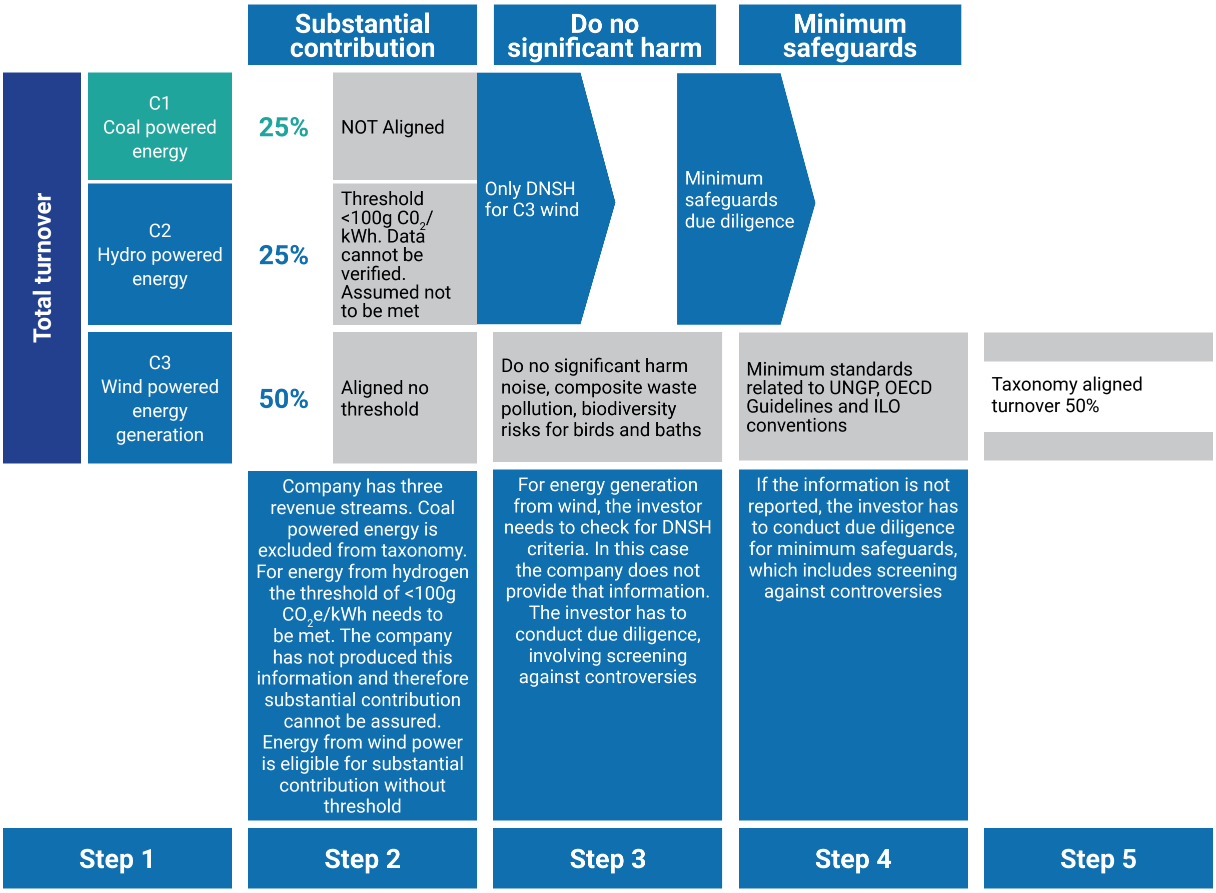
iii. Compliance with Minimum Social Safeguards

Companies and other issuers disclosing against the Taxonomy need to assess their compliance with MSS, meaning the standards embedded in:

- the principles and rights set out in the eight fundamental conventions identified in the International Labour Organization's declaration on Fundamental Rights and Principles at Work and the International Bill of Human Rights;
- the OECD Guidelines on Multinational Enterprises; and
- the UN Guiding Principles on Business and Human Rights.

This does not impact the applicability of EU law requirements which may be more stringent.[107]

The following illustration shows the process of application of the EU Taxonomy as described so far, taking the example of power generation:[108]



107 EU Technical Expert Group on Sustainable Finance (2020), Technical Report, p.17
108 EU Technical Expert Group on Sustainable Finance (2020), Technical Report, p.44

iv. Segmenting EU Taxonomy alignment using Turnover, Revenues, and where relevant, Capex and Opex

Alignment of an economic activity with the EU Taxonomy should be expressed in financial metrics: Proportion of turnover[109] aligned with the Taxonomy; capex,[110] and if relevant opex,[111] aligned with the EU Taxonomy.

Financial metric	Climate change mitigation	Climate change adaptation
Turnover	Can we counted where economic activity meets Taxonomy technical screening criteria for substantial contribution to climate change mitigation and relevant DNSH criteria.	Turnover can be recognised only for activities enabling adaptation. Turnover cannot be recognised for adapted activites at this stage.
Capex & opex	Can be counted where costs incurred (capex and, if relevant, opex) are part of a plan to meet Taxonomy technical screening criteria for substantial contribution to climate change mitigation and relevant DNSH criteria.	Can be counted where costs incurred (capex and, if relevant, opex) are part of a plan to meet Taxonomy technical screening criteria for substantial contribution to climate change adaptation and relevant DNSH criteria.

Table: Differences in calculation approaches for company climate change mitigation and adaptation[112]

This disclosure should be made as part of the non-financial statement, which may be found in annual reports or in a dedicated sustainability report. Where companies do not provide the necessary information, financial market participants may need to reach an independent judgement.

Proportion of turnover puts the share of a business's taxonomy-aligned activities in the context of its overall economic footprint. It is particularly helpful where companies are involved in multiple business activities.

Capex, in contrast, provides financial market participants and other users with a sense of a company's direction of travel. It is a key variable for assessing the credibility of a company's strategy, and it helps investors and lenders to decide whether they agree with its strategic approach.[113]

Overall, disclosure requirements in terms of financial metrics will contribute towards an accurate evaluation of the state of the transition to a low-carbon, resilient and resource-efficient economy.

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109 Defined as "the amounts derived from the sale of products and the provision of services after deducting sales rebates and value added tax and other taxes directly linked to turnover. Overall turnover is equivalent to a company's total revenues over a period of time."

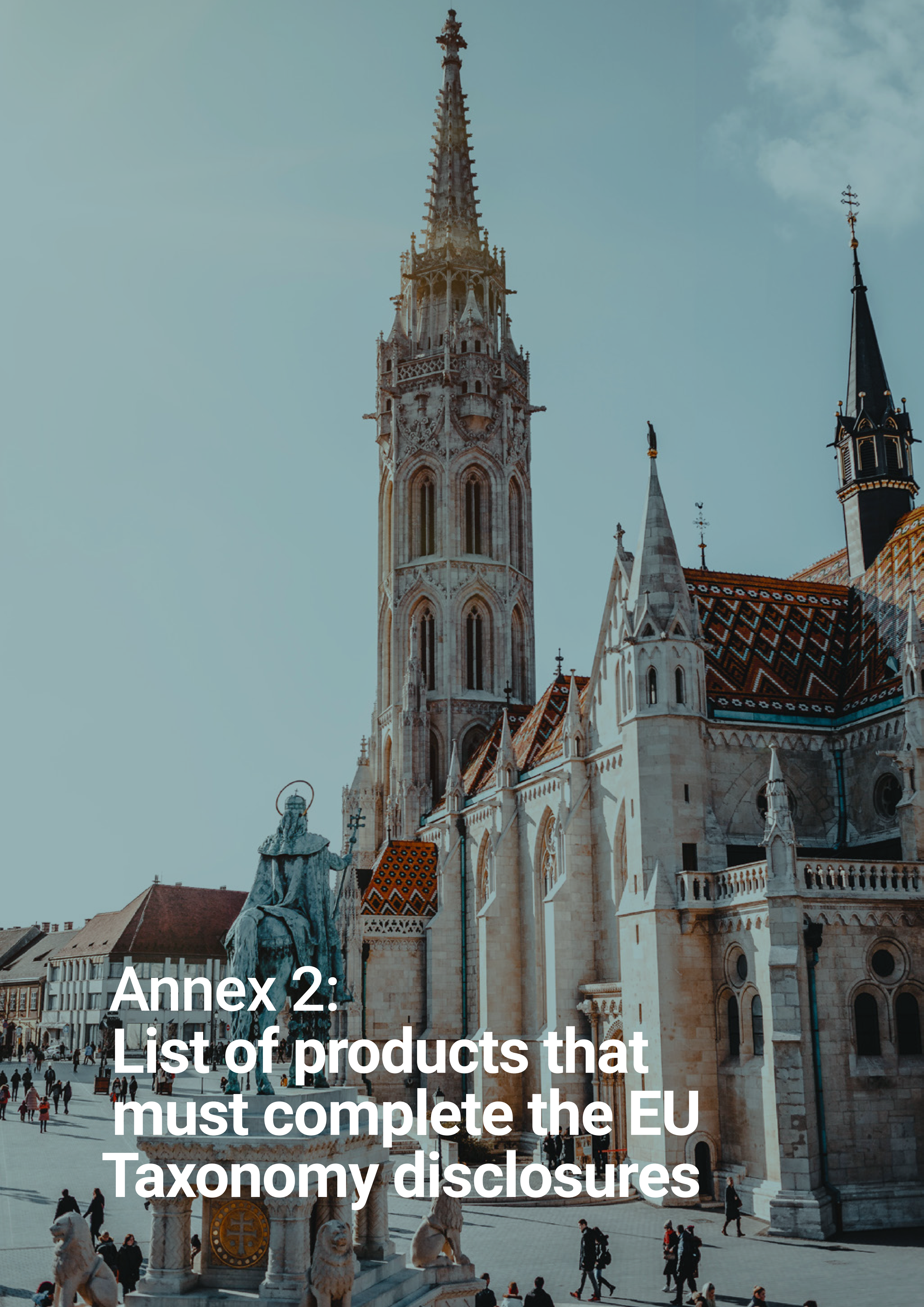
110 Capital expenditure defined as "a payment for goods or services recorded, or capitalised, on the balance sheet, rather than as expenses on the income statement."

111 Operating expenses are defined as "shorter term expenses required to meet the ongoing operational costs of running a business."

112 EU Technical Expert Group on Sustainable Finance (2020), Technical Report, p.30

113 EU Technical Expert Group on Sustainable Finance (2020), Technical Report, p.28

Annex 2:
List of products that must complete the EU Taxonomy disclosures



Which products must complete Taxonomy disclosures? 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 5.

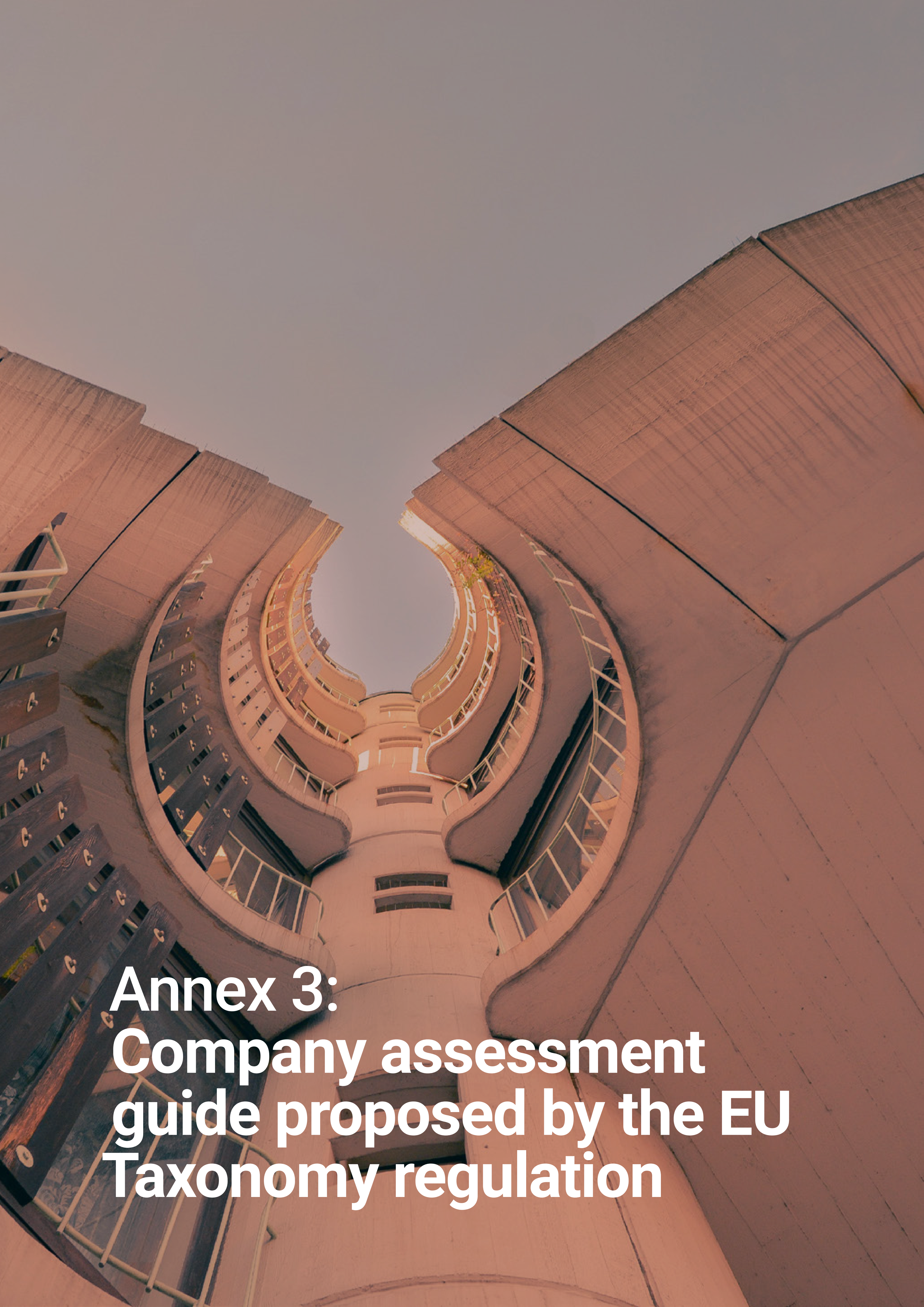
Market segment	In scope for Taxonomy disclosure

Pensions and Aset Management	▪ UCITS funds
	  ▪ equity funds
	  ▪ exchange-traded funds (ETF)
	  ▪ 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 policies (IBIPs)
Corporate and Investment Banking	▪ Securitisation funds ▪ Venture capital and private equity funds ▪ Portfolio management ▪ Index funds

Table: Financial products with Taxonomy disclosure obligations[114]

114 EU Technical Expert Group on Sustainable Finance (2020), Technical Report, p.38



Annex 3: Company assessment guide proposed by the EU Taxonomy regulation

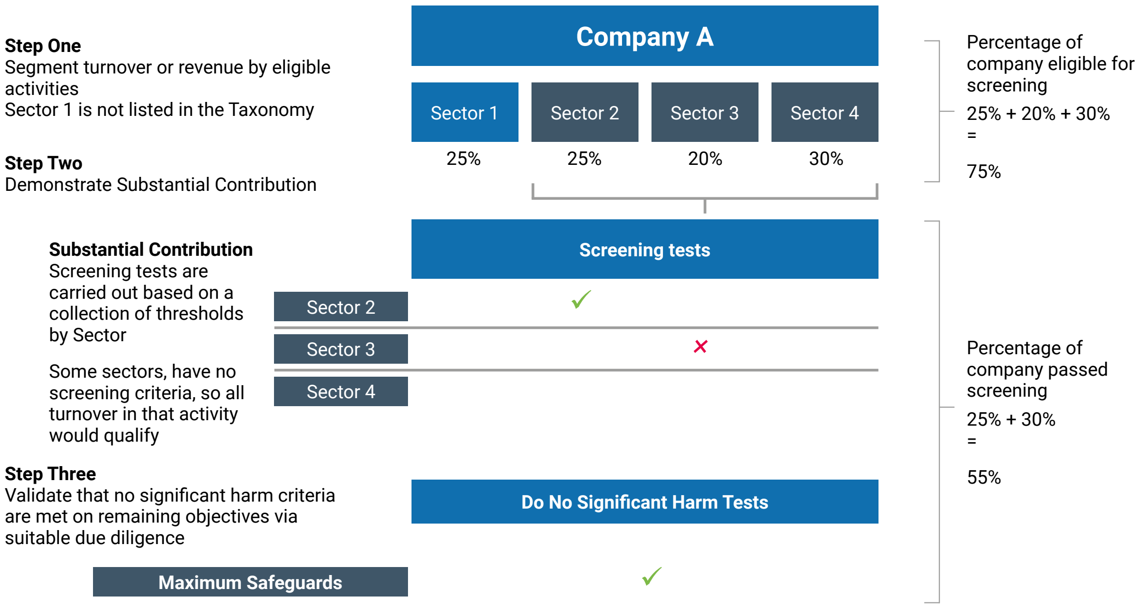
Step-by-step example of how to assess a company or investment portfolio[115]

Eligibility under the Taxonomy should be assessed on an activity basis rather than by entity. A key part of a Taxonomy assessment includes defining what part of a corporate's activity can be assessed as sustainable. This is relevant for investors in non-EU assets, or for those European companies that do not fall under the scope of NRFD.

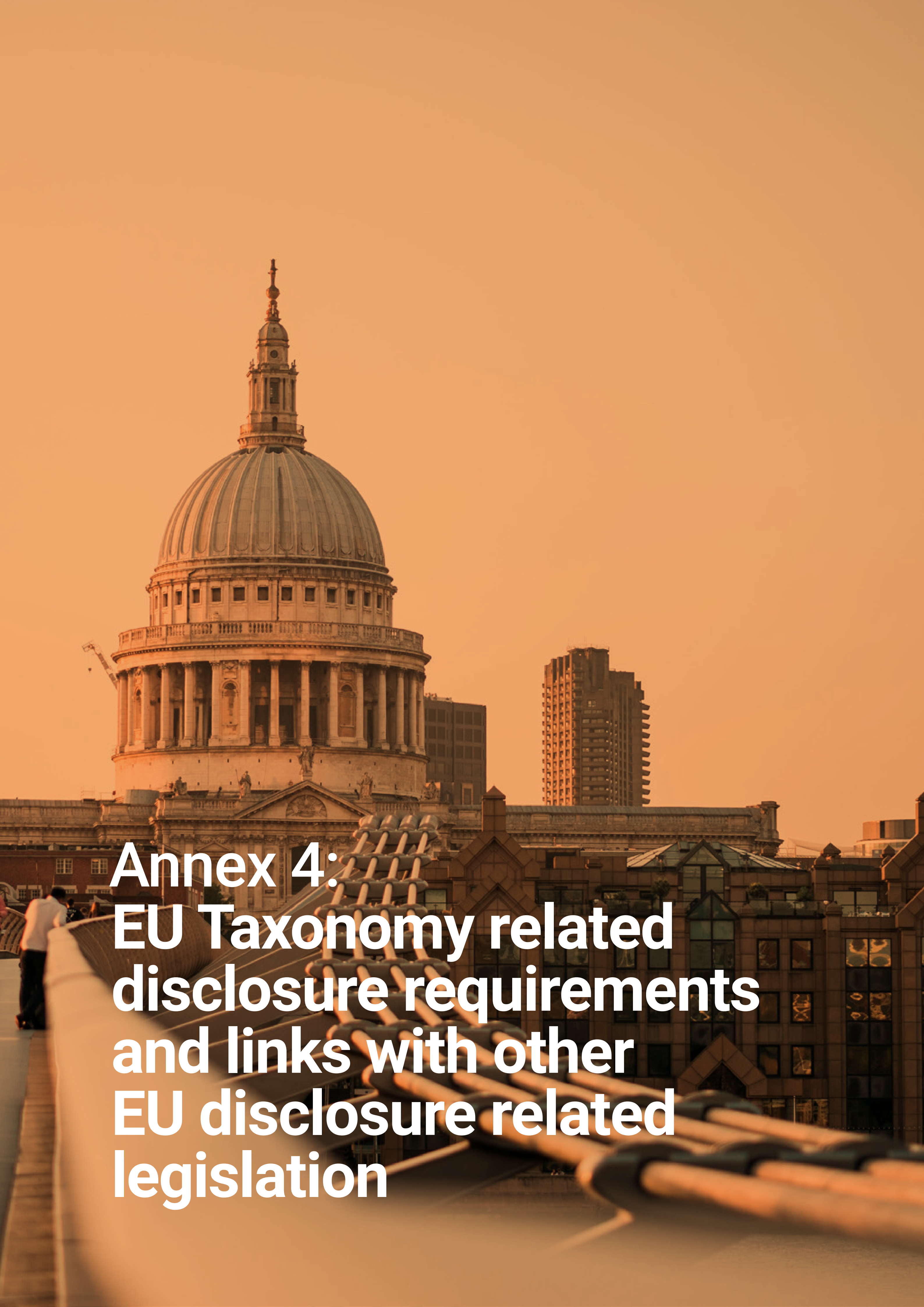
Assessing a company's Taxonomy alignment

According to the five-step process above:

1. Step one, the company's activities need to be broken down by turnover (or revenue, when appropriate), or capex and, if relevant, opex. Typically, a company will report its turnover across a number of sub-sectors, as per the example below of Company A (See Figure 11). Company A has its activities split across sectors 1, 2, 3 and 4. Based on the TEG's Taxonomy recommendations, only activities in sectors 2, 3 and 4 have technical screening criteria. These activities represent 75% of the company's turnover.
2. The second step requires Company A to validate whether or not each economic activity meets the relevant substantial contribution criteria. In the worked example below, Company A demonstrates substantial contribution to its activities in sector It does not meet the criteria in sector 3 and its activities in sector 4 have no threshold requirements and thus will pass. This means that all turnover associated with sectors 2 and 4 results in 55% of the company's turnover being Taxonomy-aligned.
3. The third step requires the Company to validate that it does no significant harm to the other environmental objectives – these are a set of due diligence qualitative and quantitative tests. If Company A can demonstrate that it does no significant harm and, via step four, meets the minimum safeguards required, then all 55% of the turnover can be applied as Taxonomy-aligned.



115 EU Technical Expert Group on Sustainable Finance (2020), Technical Report, p.49



Annex 4:
EU Taxonomy related disclosure requirements and links with other EU disclosure related legislation

Transparency and disclosure requirements applicable to banks connected with EU Taxonomy disclosures

Corporate transparency on sustainability issues is a prerequisite to enable financial market actors to properly assess the long-term value creation of companies and their management of sustainability risks. Corporate reporting is ineffective when longer-term risks are not fully transparent or are not reported in a uniform, comparable way and thus cannot be taken into account or used for comparability purposes. Corporate transparency on sustainability will not only inform market participants, but also help to steer companies in a more sustainable and long-term direction.

Banks need information on corporate sustainability for three main reasons:

- to manage sustainability risks and opportunities adequately
- to comply with mandatory disclosure obligation(s)

A. Corporate sustainability disclosures applicable to financial institutions

Non-financial Reporting Directive and Guidelines on Non-Financial Reporting: Supplement on reporting climate-related information

To foster transparency and long-termism, the EU Commission has adopted the NFRD (2014/95/EU). It requires large public interest entities with over 500 employees (including banks and insurance companies) to disclose non-financial information. Further, they should include in public reports material issues and policies implemented in relation to:

- environmental protection
- social responsibility and treatment of employees
- respect for human rights
- anti-corruption and bribery
- diversity on company boards (in terms of age, gender, and educational and professional background).

Within this framework, in June 2019, the EU Commission published **Non-Binding Guidelines on Reporting Climate-Related Information**[116] in order to foster accurate climate reporting. These guidelines integrate the recommendations of the Financial Stability Board's Taskforce on Climate-related Financial Disclosures (TCFD) **and take account of the EU Taxonomy on sustainable activities.** While not currently binding, the guidelines contain reporting requirements for companies under the scope of NFRD and include **a separate annex for banks** and insurance companies, whereby they are recommended to report, for example:

- Volume of financial assets funding sustainable economic activities that **contribute substantially** to climate Mitigation and/or Adaptation, according to the EU Taxonomy (in absolute figures and compared with total exposures, i.e. green asset ratios).

116 These guidelines are a new supplement to the existing guidelines on non-financial reporting, which remain applicable.

- Volume of collaterals related to assets or activities in climate change mitigating sectors. This information provides relevant information on, for example, retail mortgage portfolios.
- Total amount of fixed income portfolios invested in Green Bonds.

Finally, the EU Commission is also assessing responses to the public consultation on the need to revise NFRD provisions. It is expected that the scope of the Directive will be enlarged in respect to the reporting entities as well as its content, in particular on aspects related to climate change. Respondents called for consistency between the EU legislation, and more specifically, for an alignment of the NFRD with EU Taxonomy regulation requirements. It is also expected that common European Non-Financial Reporting Standards will be developed, as per the recent mandate given to the European Financial Reporting Advisory Group (EFRAG) to start preparatory technical work, though the final decision on the need for such standards is still pending.

B. Disclosures by financial markets participants

In addition to the reporting obligation under the NFRD and considerations to the Guidelines, banks that offer investment products or provide investment advisory services will, as of March 2021, have to comply with the transparency obligations under the SFDR,[117] which interlinks with the EU Taxonomy regulation.[118] See section 1.2.1 for further details and stipulation by means of the Regulatory Technical Standards.

C. Future disclosure requirements through banking regulations

In addition to the specific elements included in sustainable finance regulations, European banks will be required to disclose as part of the Pillar 3 disclosure requirements of Capital Requirements Regulation 2 (CRR II).

Large financial institutions[119] with publicly listed issuances will be required **to disclose information on ESG risks, including physical and transition risks**.[120] The European Banking Authority (EBA) is drafting implementing technical standards (ITS), specifying uniform disclosure formats and associated instructions for Pillar 3 disclosure of prudential information on ESG risks. The ITS will initially focus on climate change related risks, **aligned with the EU Taxonomy regulation**, including both quantitative and qualitative information and metrics, as well as qualitative information on other environmental, social and governance risks.

These uniform disclosure formats aim to collect sufficiently comprehensive and comparable information to allow users to assess institutions' risk profiles.[121] The EBA's work on Pillar 3 ESG disclosures will leverage other disclosure initiatives, such as **the EU Taxon-**

117 Regulation (EU) 2019/2088
118 As further defined in level 2 Regulatory Technical Standards (RTSs).
119 This mandate relates to Article 449a of CRR II.
120 As defined in the report referred to in Article 98 of the Capital Requirements Directive (CRD).
121 Requirements included in Part Eight of CRR, including Article 449a on ESG risks.

omy[122] **and the Commission's non-binding guidelines on climate change reporting and TCFD recommendations**. In the development of ITS, the EBA will follow a sequential approach. The ITS will initially focus on climate change related risks, aligned with the EU Taxonomy regulation, including both quantitative and qualitative information and metrics, as well as qualitative information on other environmental, social and governance risks. The EBA will extend the scope of the ITS at a later stage in line with the developments in the ESG framework at EU level:

- Companies will be required to disclose in the course of 2022.[123] TSC for activities that make a Substantial Contribution to water, a circular economy, pollution prevention and control, and protection of ecosystems, will be issued by the end of 2021.
- Disclosures covering activities that substantially contribute to all six environmental objectives will be required by the end of 2022.

The first review of the EU Taxonomy regulation will take place two years after it comes into force, and every three years thereafter. The regulation includes a clause allowing the Commission to consider a possible extension of the EU Taxonomy to harmful activities (the so-called "brown taxonomy") and to cover socially sustainable activities. The development of further iterations of the EU Taxonomy framework, including the Commission's work on the delegated acts, will build on inputs from TEG and the EU Platform on Sustainable Finance.

The latter was taken over from TEG[124] from Q4 2020. Established by the European Commission and comprising experts representing both the public and the private sector, this platform will advise the Commission on the subsequent development and implementation of the screening criteria, as well as monitoring their impact for review.

122 Other frameworks and regulations informing ESG risk-related disclosures include the Guidelines on Non-Financial Reporting: Supplement on reporting climate-related information, and the recommendations of the Financial Stability Board Task Force on Climate-related Financial Disclosures (TCFD).

123 TEG recognises that the timeline presents challenges to implementation, as corporate disclosures may not be available for financial market participants to use in their 2021 disclosures.

124 The European Commission set up TEG to devise the EU Taxonomy. The final report of the TEG on Sustainable Finance for the EU Taxonomy (TEG Taxonomy Report), published in March 2020, sets out their final recommendations to the EC.

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UNEP FINANCE INITIATIVE

United Nations Environment Programme Finance Initiative (UNEP FI) is a partnership between UNEP and the global financial sector to mobilize private sector finance for sustainable development. UNEP FI works with more than 350 members—banks, insurers, and investors—and over 100 supporting institutions– to help create a financial sector that serves people and planet while delivering positive impacts. We aim to inspire, inform and enable financial institutions to improve people's quality of life without compromising that of future generations. By leveraging the UN's role, UNEP FI accelerates sustainable finance.

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