



EU taxonomy and other regulations on sustainable finance: implications and outlook for financial players



Forum per la
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Introduction

EU Regulation 2020/852 introduced in the European regulatory system the **taxonomy of environmentally sustainable economic activities**, a classification of the activities that can qualify as “sustainable” based on their alignment to the environmental objectives of the European Union and their compliance with a number of social clauses.

A set of delegated acts, drawn up with the advice of the Platform on Sustainable Finance, lay out the technical criteria for establishing on which conditions each economic activity substantially contributes to at least one of the six environmental objectives identified¹, without doing significant harm to the other five objectives (“Do No Significant Harm - DNSH” clause).

The taxonomy provides guidance to:

- **undertakings**, for assessing their activities, defining corporate policies in view of enhancing their environmental sustainability and reporting to stakeholders in a more comprehensive and comparable manner;
- **investors**, for integrating sustainability themes in their investment policies and understanding the environmental impact of the economic activities in which they invest or might invest;
- **public institutions**, which can use the taxonomy to define and improve their ecological transition policies.

Pursuant to Article 8 of EU Regulation 2020/852, the organizations that are subject to the Non-Financial Reporting Directive (NFRD) – and, subsequently, to the new Corporate Sustainability Reporting Directive (CSRD) – will be required to disclose information on their alignment to the taxonomy using a number of indicators: turnover, capital expenditure and operating expenditure.

In order to delve into the practical implications of these important novelties, the Italian Sustainable Investment Forum (ItaSIF) has promoted a working group among its members to create an opportunity for discussing and sharing experiences, good practices and the criticalities found in the practical implementation of the taxonomy. The working group has discussed strategies and actions to improve engagement with undertakings relating to the disclosure of sustainability data, with a view to aligning investment portfolios to the taxonomy and enhancing the transparency of the sustainable investment products that have environmental objectives.

1. The six environmental objectives of the European Union are: climate change mitigation; climate change adaptation; the sustainable use and protection of water and marine resources; the transition to a circular economy, including with reference to waste reduction and recycling; pollution prevention and control; the protection and restoration of biodiversity and ecosystems.

An integrated analysis of the objectives and timeline of EU regulations on sustainable finance

In order to understand the potential contribution of European regulations to the growth of the sustainable finance market, it is necessary to carry out an **integrated analysis of the requirements, objectives and timeline of implementation** of the main regulatory measures that were put in place and/or that are being developed. In fact, in order to be effective, the regulations promoted by the EU Commission need to be coordinated among them and operate in a harmonic system. Listed below are the main measures adopted.

Corporate Sustainability Reporting Directive (CSRD)

On April 21, 2021, the EU Commission published a legislative proposal that updates the NFRD. One of the main novelties is the **extension of the scope of application**: indeed, the new Directive is expected to cover all undertakings based in Europe with an average number of employees in excess of 250 (while, currently, the NFRD provides for a threshold of 500 employees) and all SMEs listed on European markets (with the exception of micro-enterprises). Besides, data will have to be reported based on **common reporting standards** that will be developed by the European Financial Reporting Advisory Group (EFRAG) and adopted by the EU Commission with two delegated acts, i.e., a high-level one by the end of 2022 and a specific one for each economic sector by the end of 2023. In addition, EFRAG will work out **ad hoc standards for the SMEs**. The standards will be developed according to the **double materiality** principle: undertakings will have to provide information on both the environmental and social risks to which they are exposed and the impact of their business on sustainability factors. Furthermore, the information disclosed as part of the CSRD will be audited according to the method of limited assurance² and will have to be published in electronic format. According to the EU Commission's proposal, the Directive should enter into force starting from 2023.

Regulation 2020/852 on the taxonomy of environmentally sustainable economic activities (Taxonomy Regulation - TR)

Article 8 of the TR requires that the undertakings that are subject to the NFRD (and, later, to the CSRD) publish **information on the alignment of the activities to the taxonomy**. On July 6, 2021 the EU Commission published the final version of the delegated act that sets out in detail the contents, timeline and methods for publishing this information. In particular, **non-financial undertakings** are required to publish information on: **the proportion of the net turnover** derived from products or services that are taxonomy-aligned; **the proportion of the capital expenditure (Capex) and of operating expenditure (Opex)** related to assets or processes associated with taxonomy-aligned economic activities. **Financial companies** are required to publish **Key Performance Indicators (KPIs) that show the proportion of taxonomy-aligned economic activities in their financial activities**. In this case, the KPI is the ratio between investments and financial assets taxonomy-aligned (numerator) and total investments and financial assets (denominator). The requirements will be implemented gradually between 2022 and 2024.

Regulation 2019/2088 on sustainability-related disclosures in the financial service sector (Sustainable Finance Disclosure Regulation - SFDR)

The Regulation requires financial market participants and advisers to disclose how they consider the **Environmental, Social and Governance (ESG) risks and impacts as an entity and in terms of products**. The Regulation imposes **specific disclosure requirements for the products that promote environmental or social characteristics (Art. 8 SFDR) and for the products whose objective is sustainable investment (Art. 9 SFDR)**. Besides, pursuant to Articles 5 and 6 of TR, **the products that invest in activities with environmental objectives** are required to provide information on the **percentage of taxonomy-alignment of the investments**. As such, this forms a subset of products among those that fall under Articles 8 or 9 of the SFDR.

The European Supervisory Authorities (ESAs) have drawn up the **Regulatory Technical Standards (RTS)** for implementing the SFDR. The RTS include detailed indications on how to disclose: adverse impacts on sustainability themes based on specific indicators (Principal Adverse Impact Indicators - PAIIs); characteristics of the products under Art. 8 and Art. 9; taxonomy-alignment of the products whose objective is environmentally-sustainable investment. The EU Commission will adopt all the RTS in the course of 2021 in a single document ("Single Rulebook"); the requirements will apply **starting from July 2022**.

2. The limited assurance certificate under ISAE 3000 is characterized by: understanding the subject-matter of the audit; identification of audit risks; on-site audits, process tests, tests on controls, tests on statistical samples and materiality tests; limited procedures (for example, audits of selected sites, coverage of some geographic areas, areas of activity or companies); description of the engagement, referencing the responsibility of the management and of the auditor; conclusions expressed in a negative form on the proper application of the principles of preparation adopted (for example: "We have not become aware of any aspects that lead to believe that the Sustainability Report is not compliant with the principles of preparation adopted"). As opposed to the limited assurance, the reasonable assurance is much more complex and pervasive.

FIGURE 1. CSRD, TR and SFDR: addressees, type of information and timeline

Regulatory act	Addressees	Information provided	Data available starting from
Corporate Sustainability Reporting Directive - CSRD³	large, listed and unlisted EU undertakings ⁴ and listed SMEs (except micro-companies). Non-EU companies listed on EU regulated markets, and the EU subsidiaries of non-EU companies	information on the organization sustainability characteristics of corporate activities such as: social, employee and environmental matters, human rights, bribery and corruption	<i>large undertakings:</i> from 2024 (data relating to FY 2023) <i>listed SMEs:</i> from 2026 (data relating to FY 2025)
Taxonomy Regulation - TR	undertakings subject to the NFRD (in the future to the CSRD): both non-financial undertakings and financial market participants	information on the organization (Art. 8 TR⁵) <i>non-financial undertakings:</i> taxonomy-aligned turnover, Capex and Opex <i>financial undertakings:</i> % of alignment to the taxonomy of investments and assets information on products (Art. 5 and Art. 6 TR) <i>products under Art. 8 and Art. 9 SFDR that invest in environmental objectives:</i> % of alignment to the taxonomy ⁶	Art. 8 TR <i>non-financial undertakings:</i> from 2022 % of activities eligible for the taxonomy ⁷ from 2023 % of activities aligned to the taxonomy ⁸ <i>financial market participants:</i> from 2022 % of exposure to the activities eligible for the taxonomy from 2024 % of exposure to the activities aligned to the taxonomy and, hence, % of alignment to the taxonomy Art. 5 and Art. 6 TR from July 2022 disclosure on alignment to mitigation and adaptation objectives from 2023 disclosure on the other four environmental objectives under the taxonomy ⁹
Sustainable Finance Disclosure Regulation - SFDR	financial market participants and advisers	disclosure on the organization risks associated with ESG factors and impacts on sustainability themes ¹⁰ disclosure on products data on the integration of the risks associated with ESG factors and ESG impacts in respect of all products and specific information in respect of the products that promote environmental or social characteristics (Art. 8 SFDR) and whose objective is sustainable investment (Art. 9 SFDR)	from March 2021 organization and products related ESG information according to Level 1 Regulation from July 2022 information to be disclosed according to the Regulatory Technical Standards (RTS)

3. The analysis is based on the contents outlined in the proposal published by the EU Commission on April 21, 2021.

4. Under the CSRD, undertakings with at least 250 employees and assets exceeding €20 million and/or a turnover of €40 million+ qualify as large undertakings. So, as compared to the NFRD, the minimum threshold of 500 employees no longer applies.

5. The analysis is based on the contents outlined in the July 6, 2021 version of the delegated act, subject to a four-month scrutiny by the Parliament and the Council (that can be extended by two months).

6. Pursuant to the technical provisions of the ESAs.

7. The activities "eligible" for the taxonomy are the economic activities for which screening technical criteria are available in order to verify their substantial contribution to at least one of the six environmental objectives of the EU and, at the same time, the absence of adverse impacts on the other objectives (DNSH).

8. Among the activities eligible for the taxonomy, some are "aligned" to the evaluation criteria and, hence, aligned to the taxonomy: these economic activities contribute to at least one of the environmental objectives of the EU and do not cause significant harm to any of the other objectives.

9. The analysis is based on the contents outlined in the proposal of regulatory technical rules published by the ESAs in March 2021.

10. According to the PALLs contained in the technical rules of the ESAs.

Overall, the aim of the CSRD, the TR and the SFDR is to **enhance market transparency**, i.e., to boost the quantity, quality and comparability of the sustainability-related information concerning undertakings, financial market participants and products.

Each of the three regulatory acts is functional to the production of data and information serving to meet the transparency requirements of the other two acts. Pursuant to the CSRD, the undertakings that are required to publish sustainability reporting have to disclose the alignment to the taxonomy of their turnover, capital expenditure and operating expenditure (Art. 8 TR). This data is used by financial market participants to disclose, in turn, the alignment to the taxonomy of their assets (Art. 8 TR, in the case of financial market participants subject to the CSRD) as well as to disclose the percentage of taxonomy-alignment of the products that invest in activities with environmental objectives (Art. 5 and Art. 6 TR, in respect of the products under Art. 8 and Art. 9 SFDR).

FIGURE 2. Disclosure requirements for financial market participants

Relating to the organization	percentage of the taxonomy-alignment of assets*	Art. 8 TR
	integration of sustainability risks in investment policies	Art. 3 SFDR
	analysis of the principal adverse impacts on sustainability factors	Art. 4 SFDR
Relating to products	integration of sustainability risks (in respect of all products)	Art. 6 SFDR
	analysis of the principal adverse impacts on sustainability factors (in respect of all products)	Art. 7 SFDR
	specific information in respect of the products that promote environmental or social characteristics or whose objective is sustainable investment	Art. 8 and Art. 9 SFDR
	percentage of the taxonomy-alignment of products whose objective is environmentally-sustainable investment*	Art. 5 and Art. 6 TR

* Requirements under the taxonomy

Within this framework, three themes are crucial for the development of the sustainable finance market:

1. the use of the taxonomy for financing the transition;
2. the balance between availability and comparability of ESG data;
3. the importance of enhancing the efficacy and accessibility of disclosure on sustainable products, for the benefit of advisers and clients.

In relation to these themes, it is necessary to ensure clarity and coordination of EU policies as well as to mainstream good practices among participants.

The taxonomy as a tool for financing the transition

The taxonomy enables to examine each operating line and production plant, as part of investment analyses or the evaluation of a company's positioning versus competitors, through KPIs such as:

- turnover from taxonomy-aligned production activities;
- capital expenditure (Capex);
- operating expenditure (Opex).

Among the requirements under Art. 8 of the TR, the disclosure of the percentage of **taxonomy-aligned Capex** is particularly important in view of transitioning the economy away from fossil fuels. This is a **dynamic and forward-looking indicator that**, differently from the turnover (which is more “static” and backward-looking), **refers to the strategic plans drawn up by companies** aiming for a stepwise decarbonization within a specified time frame. Likewise, it is important to understand, through the analysis of operating expenditure (**Opex**) to what extent the company is pursuing the **intermediate targets** of the ecological transition strategic plan.

This data enables investors to carry out an **analysis** of the alignment of companies to environmental objectives, taking account of their decarbonization plans. This should **steer, with heightened transparency and consciousness, towards sustainable investments** (low-carbon or carbon-neutral, e.g. renewable energy). In addition, **in higher-climate-impact industries** (e.g., energy, construction and transport), this information enables to **select the undertakings that are set on a course of ecological transition**. Finally, thanks to the availability of data on the taxonomy-alignment of corporate plans, investors can boost the effectiveness of their **engagement actions**, by measuring their effects over time and strengthening their dialogue with investee companies.

In order to finance these plans, undertakings mostly rely on banks (through general purpose loans, green loans or sustainability-linked loans) **or issue sustainable bonds** such as ESG-linked bonds or green bonds (which, in the future, might be in line with the European Green Bond Standard). The greater availability of data on turnover, capital expenditure and operating expenditure enables financial market participants to **identify the percentage of taxonomy-alignment of such loans or bonds**. In turn, investors and banks alike will be able to disclose this information to the market in their reporting under Article 8 of the TR.

Under the new strategy for sustainable finance of the European Commission published on July 6, 2021, one of the main lines of action relates to strengthening the role of sustainable finance in supporting the transition. Indeed, amongst other, the strategy mentions the introduction of minimum sustainability criteria for the financial products that promote ESG characteristics and shared labels for transition bonds, sustainability-linked bonds and ESG benchmarks.

Data availability and comparability: a complex balance

As mentioned earlier, the data on the taxonomy-alignment of economic activities is useful for:

- **undertakings**, as a starting point for analyzing their positioning versus competitors and their progress towards decarbonization;
- **financial players**, to disclose information on their organization (under Art. 8 of the TR) and products (under Art. 5 and Art. 6 of the TR).

The efficacy of European transparency regulations depends on the **availability of data by the effective date of the TR requirements**. Likewise, the **data** needs to be **reliable and comparable**: undertakings must report according to common standards and, where data providers are involved, transparency on the calculation methodologies used is necessary so as to forestall the risk of greenwashing.

Equally important, **more undertakings should disclose information on sustainability themes**. Article 8 of the TR applies to the undertakings that are already required to prepare a sustainability report (at present pursuant to the NFRD and in the future pursuant to the CSRD). If the scope of application of the CSRD remains unaltered compared to the one proposed by the EU Commission in April 2021, the undertakings that publish the sustainability report are set to increase from 11,000 to almost 50,000. Many undertakings, SMEs included, could join on a voluntary basis. Still, **availability of this information takes time**: according to the CSRD proposal, large-cap reporting will be available starting from 2023 (versus 2026 for listed SMEs). Besides, the process of approval by the European Parliament of the proposed Directive will not start before autumn 2021; thus might imply postponements.

The disclosure in respect of the financial products that invest in environmental objectives (Articles 5 and 6 of the TR) will be mandatory from January 2022: as things stand now, the disclosure of the products' taxonomy-alignment

needs data (disclosed by undertakings pursuant to Art. 8 of the TR) that will be available only from 2023 for the undertakings with 250+ employees and from 2026 for listed SMEs.

An enhancement of the scope of application of the CSRD is fundamental for two reasons. In the first place, as reported by ESMA in February 2021, a minor proportion of EU-domiciled funds is invested in undertakings that are required to publish sustainability reporting (equity funds: 26%; corporate bond funds: 20%). Additionally, 61% of the assets are invested in non-EU undertakings which, as such, are not subject to the CSRD. Furthermore, pursuant to the delegated act that defines in more detail the methods of disclosure under Article 8 of the TR, **the calculation of taxonomy-aligned investments can only include the information published by undertakings that are subject to the NFRD**. As a result, in principle, the data on SMEs and on non-EU undertakings cannot be reckoned for calculating the KPIs of financial market participants. This regulatory mismatch complicates the possibility to effectively apply the transparency requirements provided for financial products with environmental objectives.

The use of estimates and data supplied by data providers in order to calculate the percentage of taxonomy-alignment of financial players **could help increase the amount of information available to participants**. However, the heterogeneity of calculation methodologies could generate inconsistent evaluations and increase opacity and greenwashing.

In this regard, it is important to **promote**:

- 1. the mainstreaming of sustainability reporting among undertakings** (above all SMEs);
- 2. maximum transparency in respect of the calculation methodologies** used for estimates and scores. The delegated act itself, relating to Article 8 of the TR, allows non-EU financial and non-financial companies to use estimates, on condition that they publish detailed information on the methodology adopted for the calculation of data.

The transparency of disclosure on sustainable products

Starting from March 10, 2021, the SFDR introduced new transparency rules for defining, testing and monitoring financial products and insurance products with a financial content.

On April 21, 2021, the EU Commission adopted **six amending Delegated Acts on the MiFID II, IDD, UCITS, AIFM and Solvency II Directives** with a view to enhancing transparency on the themes of sustainability in financial services. In the industries of asset management, insurance, reinsurance and investments, in order to comply with the obligations of the **fiduciary duty**, it will be necessary to integrate **sustainability risk analysis into investment selection and monitoring**.

As regards the new Delegated Regulations for the **MiFID II and IDD**, advisers are required to **take into consideration clients' sustainability preferences during the process of profiling** financial and insurance needs and of evaluating the adequacy of the offer. The amendments to the Regulations for the **UCITS, AIFM and Solvency II Directives** also impose upon financial market participants the obligation to integrate the themes of sustainability in the **design of products**, in the **definition of target markets** (i.e., the addressees identified for the proposal of a specified product), in the **monitoring**, in the **choice of the distribution channel** and, finally, in the **revision of products**.

In this area, it is increasingly and strategically important to improve the knowledge, comprehensibility, efficacy and accessibility of the templates for pre-contractual information and periodical reporting relating to sustainable products. This objective must be taken into consideration above all to enhance the value of the ability of advisers to detect and understand clients' sustainability expectations. Intermediaries must be able to understand and explain the new documentation, including its many indicators, in order to represent to the client the potential impact of ESG factors on investments' profitability and, vice versa, investments' impacts on ESG factors, above all in the mid-to-long term. The client will have to indicate the share of its investment portfolio intended to be allocated to sustainable activities. However, in order to evaluate all possible beneficial or adverse consequences, the role of advisers will be increasingly unavoidable to understand and meet clients' expectations in the most appropriate manner.

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