ICMA
International Capital Market Association

Ensuring the usability of the EU Taxonomy

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List of abbreviations and acronyms

CSRD: Corporate Sustainability Reporting Directive

DNSH: Do No Significant Harm

ESG: Environmental, Social and Governance

EuGB Regulation: European Green Bond Regulation

EU GBS: EU Green Bond Standard

EC: European Commission

GAR: Green Asset Ratio

GBP: Green Bond Principles

GIR: Green Investment Ratio

IPSF: International Platform on Sustainable Finance

KPIs: Key Performance Indicators

MS: Minimum Safeguards

NACE: Nomenclature of Economic Activities which is the European statistical classification of economic activities.

NFRD: Non-Financial Reporting Directive 2014/95/EU

PSF: Platform on Sustainable Finance of the EU

SC: Substantial Contribution

SF: Sustainable Finance

SFDR: Sustainable Finance Disclosure Regulation 2019/2088

SFDR Disclosures: The product-level Taxonomy disclosures

SME: Small and medium-sized enterprise

TEG: Technical Expert Group

TSC: Technical Screening Criteria

Executive summary

The EU Taxonomy is remarkable for its ambition as well as its complexity. Originally designed as a classification system to identify sustainable economic activities, its role has been expanded by legislation to serve both as a metric for sustainable reporting and as a benchmark for sustainable financial products, as well as a way to measure progress towards the policy objective of a sustainable financial and economic system in the EU. The EU Taxonomy has created a precedent that many other jurisdictions have followed with around 30 official sector taxonomies now existing or under development.

The EU Taxonomy is also unique in its comprehensive design, which requires economic activities to (i) make a substantial contribution to one or more environmental objectives; (ii) Do No Significant Harm (DNSH) to any of the objectives, (iii) comply with the Minimum Safeguards (MS), as well as (iv) with Technical Screening Criteria (TSC) which qualify both the Substantial Contribution (SC) and the DNSH provisions.

The implementation of reporting requirements under the Taxonomy Regulation is now under way with disclosures applying to both non-financial and financial entities and being phased in from January 2022. These involve, among other things, the reporting of Taxonomy eligibility and alignment information at both an entity-level and product level under the requirements of Article 8 of the Taxonomy Regulation and the related Delegated Regulation and the Sustainable Finance Disclosure Regulation (SFDR). While not imminent in their application, the legislative proposals for the future Corporate Sustainability Reporting Directive (CSRD) and the EU Green Bond Standard that will both require reporting of Taxonomy alignment information are also now under discussion among the co-legislators.

It is in this context that we identify important usability issues that are likely to impair the ability of all concerned parties to align with the EU Taxonomy. These are in summary: (i) the requirement for highly granular data for TSC purposes; (ii) the reliance on EU legislation and criteria in an international market; (iii) inconsistency in the use of estimates and third-party data; (iv) the absence of proportional arrangements for smaller companies and projects; (v) dynamic TSC for substantial contributions where the change over time gives rise to the need for grandfathering; and, (vi) the use of an economic activity-based classification system (NACE) for complex projects.

In this paper we discuss emerging solutions to Taxonomy usability challenges from market practice and regulatory developments. These include the past recommendations of the European Commission's Technical Expert Group; flexibility in DNSH evaluations proposed in EU sustainable finance regulations; reporting under the future Corporate Sustainability Reporting Directive; the precedents set by the EU NGEU Green Bonds and other issuers; the international approach of the Common Ground Taxonomy of the International Platform on Sustainable Finance; and the work to date of the Commission's Platform on Sustainable Finance of which ICMA is a member.

Considering the challenges identified in this paper, we are making five key recommendations to EU co-legislators and regulators. The first 3 recommendations are designed to address broad usability concerns for both product alignment and sustainable reporting, while the last two address issues that are more specific to assessing the Taxonomy alignment of green and sustainability bonds.

Key recommendations for EU co-legislators on the EU Taxonomy

1. Allow flexibility on alignment with the Do No Significant Harm and Minimum Safeguards in all cases;
2. Enable Technical Screening Criteria adaptation to non-EU jurisdictions to facilitate international usability;
3. Allow estimates and third-party data based on a common methodology to assess Taxonomy alignment;
4. Simplify NACE classification for complex green and sustainability projects; and
5. Grandfather the Taxonomy alignment of the legacy green bond market for Green Asset Ratio/ Green Investment Ratio and the SFDR disclosures.

The views in this paper are expressed on behalf of ICMA and its constituencies. It is important to note that this paper is not designed to address questions relating to what should be classified as sustainable. It is therefore not topical in relation to the recent Taxonomy Complementary Climate Delegated Act covering certain natural gas and nuclear-related activities.

I. Introduction

Taxonomies have come to be developed and used in sustainable finance as classification systems. Market based efforts have reflected a sectoral and project-based methodology in line with the approach of the sustainable finance market. The official sector has also developed taxonomies, in some cases based on identifying green and/or sustainable activities building on classification systems developed for statistical and economic analysis purposes.

Official sector taxonomies may incorporate additional considerations beyond classification purposes. They are also often progressively, and not necessarily by initial design, referenced in financial and prudential regulation which can lead to usability and data challenges among other issues. In May 2021 ICMA published a paper that provides an international overview of both official sector and market-based taxonomies as well as recommendations for future taxonomy initiatives (see Overview and Recommendations for Sustainable Finance Taxonomies).

With detailed eligibility criteria for climate change recently finalised[1], it is now time for both the real economy and the financial sector to implement the Taxonomy both in the form of disclosures and through the launch of financial products, which will test its usability. The period between 2022-2024 will therefore be the initial experimentation phase, as the Taxonomy disclosures gradually come into force.

In this context, existing research and market feedback to date show that the implementation of the EU Taxonomy could be seriously impaired by usability issues that we identify in this paper. We review both conceptual and practical solutions to these issues that exist, or are emerging including from market practice. We then make key recommendations to EU co-legislators and regulators.

1 See Climate Delegated Act of 9 December 2021.

II. Scope and complexity of the EU Taxonomy

The EU Taxonomy is an ambitious initiative to define and scope environmentally sustainable economic activities. It is designed to serve the EU's objective, as part of its Sustainable Finance Action Plan, to steer both private and public capital towards a sustainable economy. It will also be used as the main classification tool to identify and monitor green economic activities, and as a reference for disclosure obligations and official labels for financial products.

The EU Taxonomy is framed by the Taxonomy Regulation 2020/852. An economic activity qualifies as "environmentally sustainable" if it fulfils the following conditions:

- Substantial Contribution (SC) to one or more environmental objectives[2];
- Do No Significant Harm (DNSH) to any of the environmental objectives;
- Compliance with Minimum Safeguards (MS); and;
- Compliance with the Technical Screening Criteria (TSC) which qualify both the Substantial Contributions (SC) and the DNSH.

Distinct TSC for SC and for DNSH are provided for each given economic activity under the relevant delegated act(s) of the Taxonomy Regulation[3]. With the Climate Delegated Act becoming law on 9 December 2021, the EU Taxonomy is now operational regarding the climate change mitigation and adaptation objectives. The technical work on the remaining four environmental objectives is ongoing in the EU Platform on Sustainable Finance. These will also eventually become law through delegated acts.

In Annex 1 of the Climate Delegated Act setting the criteria for the mitigation objective, the SC TSC requirements are varied. Some low-carbon activities and enabling activities are "green" by definition, i.e., without any environmental performance threshold or lifecycle analysis being required in some cases (e.g., electricity generation from wind power). Others, especially transitional activities, are subject to performance thresholds and/or process-based requirements, such as due diligence or verification of lifecycle GHG emissions. In general, the bar of ambition for the required environmental performance, where applicable, is set high.

The DNSH criteria, on the other hand, may vary depending on the potential presence and nature of environmental risks for each economic activity, but they are mostly qualitative and process based. As an example, the circular economy DNSH criteria may include requirements to assess the availability and adopt techniques that support the reuse and use of secondary raw materials and design for high durability, recyclability, easy disassembly, and adaptability of manufactured products. The generic DNSH criteria for climate change adaptation, pollution prevention and control regarding the use and presence of chemicals, and in relation to biodiversity and ecosystems are included as specific appendixes under the Climate Delegated Act.

MS represent primarily the social and governance aspect of the EU Taxonomy and apply rather to the undertaking conducting the economic activity in question. MS require compliance with the OECD Guidelines for Multinational Enterprises, the UN Guiding Principles on Business and Human Rights, including the relevant International Labour Organisation (ILO) texts and the International Bill of Human Rights.

2 The six environmental objectives of the EU Taxonomy are climate change mitigation, climate change adaptation, sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control, and protection and restoration of biodiversity and ecosystems.
3 For more information on the EU Taxonomy, please see ICMA's Overview and Recommendations for Sustainable Finance Taxonomies, p.6-9.

III. Application of the EU Taxonomy

The EU Taxonomy has two main scopes of application in the EU financial sector. These are the product alignment and regulatory reporting.

1. Product alignment

The Taxonomy Regulation requires EU Member States and the EU itself to use the EU Taxonomy when designing or introducing requirements for green financial products. As such, the EU Taxonomy will be referenced in official sector green public measures, standards, and labels.

The EU GBS is the most prominent official sector standard from the EU in sustainable finance, and it is currently in the EU legislative process. As background, in July 2021, the EC released its proposal for a Regulation on European green bonds that builds on the recommendations of the TEG, which included ICMA as a member. The EuGB Regulation, as proposed by the EC, aims to establish a voluntary standard for green bond issuance that will co-exist with market standards such as the GBP[4]. The EU Taxonomy is the cornerstone of the EU GBS as it allows only green projects aligned with the Taxonomy to be financed via an issuance using the designation.

Another example is the ongoing project for an EU Ecolabel for retail financial products. The draft label adopts an overall "green threshold" for each retail financial product in scope (e.g., 70% for UCITS bond funds) that needs to be based on the investee entities' turnover and/or CapEx "compliant" with the EU Taxonomy, or Taxonomy "compliant" proceeds in the case of green and sustainability bonds.

2. Regulatory reporting

The regulatory Taxonomy disclosures started to apply as of January 2022, with a phased and gradual approach for non-financial entities. The Taxonomy disclosures have two dimensions of application:

i. One that applies at an entity-level to entities subject to the NFRD 2014/95/EU (and in future, to the CSRD) as per Article 8 of the Taxonomy Regulation and the Article 8 Delegated Regulation.

ii. One that applies (mainly) to asset managers/owners at a product-level to showcase the Taxonomy-alignment of their funds under the SFDR 2019/2088.

Taxonomy disclosures at entity-level require all NFRD entities (both non-financial and financial) to disclose in their non-financial statements how and to what extent their activities are associated with the Taxonomy. By way of background, the NFRD has been in force since 2018 and already requires large, listed companies with more than 500 employees to report on non-financial aspects related to environmental, social, employee, human rights, anti-corruption, and bribery matters. The current scope of the NFRD captures around 11.000 companies in Europe. In April 2021, the EC adopted a proposal for a CSRD that will replace the existing NFRD and expand its scope to cover additional entities, including all large companies and listed companies/SMEs (except listed micro-companies). This means that Taxonomy disclosures would eventually become applicable to around 50.000 companies in Europe.

According to Article 8 of the Taxonomy Regulation, for non-financial NFRD entities it will be mandatory to report the turnover, CapEx, and OpEx associated with the Taxonomy-aligned activities. When reporting on Taxonomy alignment, these NFRD entities are also obliged to assess compliance with the DNSH TSC and the MS in addition to the SC TSC. Also, non-financial entities should provide for a breakdown of the KPIs (turnover, CapEx, and OpEx) based on the economic activity pursued,

4 For further reference, ICMA published a **note** that analyses the proposed EuGB Regulation. ICMA also published an **update** on 05.01.2022 where it further commented on the amendments proposed by the Rapporteur of the file in the European Parliament.

including transitional and enabling activities, and the relevant environmental objective. The Article 8 Delegated Regulation specifies the turnover, CapEx and OpEx metrics in detail and with reporting templates.

For Article 8 reporting, banks and big asset managers/owners will use the GAR and GIR metrics, respectively. GAR/GIR reflect the Taxonomy-aligned share of exposures versus the totality of balance sheet exposures or assets in scope. The Article 8 Delegated Regulation provides in detail how these KPIs should be calculated, their content, scope, methodologies as well as reporting templates. It is important to note that GAR/GIR are calculated differently depending on the type of product. For mainstream investment products (e.g., equity or vanilla bonds), they reflect the Taxonomy-alignment of the investee (at issuer level) while for green and sustainability bonds the Taxonomy assessment is at the level of the use of proceeds.

The product-level Taxonomy disclosures ("SFDR disclosures") are required by Articles 5 to 7 of the Taxonomy Regulation and incorporated into the SFDR reporting. On 22 October 2022, the ESAs published their proposed RTS on the content and presentation of pre-contractual and periodic Taxonomy disclosures. The SFDR disclosures follow the same logic as GAR and GIR when it comes to calculating Taxonomy alignment (e.g., by looking at the alignment of use of proceeds in case of a green bond and at the alignment of the issuer in case of a mainstream financial product).

IV. Usability challenges for Taxonomy alignment

The EU Taxonomy raises several significant usability challenges for both investors and issuers when assessing alignment that impact product usability and regulatory reporting.

1. Requirement for highly granular data for TSC purposes

Assessing alignment with the DNSH TSC requires granular data that in many cases prove to be unavailable. There are several research pieces and studies that evidence the limitations of a strict DNSH approach (see table below). We noted especially:

- The study "Testing the taxonomy: insights from the PRI Taxonomy Practitioners Group" (published by the PRI in September 2020) revealed for green bond funds that while the assessment of existing green bonds against the SC TSC criteria was generally possible (thanks also to assumptions and proxies), the DNSH TSC criteria seemed impossible to assess by almost all participants due to the unavailability of granular data at project/use of proceeds-level. Most investors eventually relied on the issuer-level green bond frameworks and processes in place to manage environmental and social externalities as well as ESG controversy data obtained from third parties or otherwise, as a proxy to determine the DNSH and MS compliance.
- The study "Testing the application of the EU Taxonomy to core banking products" (published by UNEP FI & EBF in January 2021), which focused on banking products, found that a strict alignment approach led to no cases being able to qualify as Taxonomy aligned out of 26 published cases.
- "EU Taxonomy Study – Evaluating the market readiness of the EU Taxonomy criteria for buildings" (a collective study of several European building councils and associations published in March 2021) found only 1 out of 62 cases to be fully Taxonomy-compliant and noted that some DNSH TSC criteria, such as the one for the climate change adaptation, proved to create more data gaps than others.
- The Do No Significant Harm Handbook (published by Maples Group, ELS Europe and Frankfurt School-UNEP Collaborating Centre in December 2021) showed that a single construction development project (at an early design and planning stage) could involve 25 different economic activities. The DNSH analysis for only 3 selected economic activities further generated 17 DNSH criteria against which strict compliance with the DNSH TSC was only achievable for three DNSH criteria.

Overview of referenced studies

Authors	Scope	Result	Other notable points
UN PRI	40 funds with different asset classes (e.g., listed equity, fixed income, real estate).	Absence of DNSH data and its qualitative nature were found particularly challenging and required reliance on proxies such as UN Global Compact, IFC standards and NGO assessments.	Other challenges: resource intensive nature of Taxonomy assessment, interpretable nature of some TSC, the use of NACE, and the application of EU standards outside EU.
UNEP FI & EBF	40 transactions or client relationships by banks of various nature.	Strict alignment approach led to **0 cases** being able to qualify as Taxonomy aligned out of 26 published case studies, mostly a result of data unavailability and quality and lack of evidence related to the DNSH TSC.	Key challenges: unspecified use of proceeds, data-related challenges especially for SMEs and non-EU assets, operational complexities of assessment and classification which require the use of NACE, new IT development and related-costs, and increased documentation, monitoring and time.
DGNB, GBCe, DK-GBC, ÖGNI, CPEA	62 real building case studies located in 11 different EU countries.	**Only 1 case study** rated as fully Taxonomy-compliant. Some DNSH TSC criteria such as the ones for climate change adaptation created more data gaps than others	Findings on DNSH TSC criteria in line with the findings of the PRI and UNEP-FI & EBF studies).
Maples Group, ELS Europe, Frankfurt School UNEP Collaborating Center	A single development construction project in the EU.	The DNSH requirements only for the selected 3 economic activities generated 17 DNSH criteria, out of which **only 3 were in strict compliance** with the DNSH TSC.	The breakdown of the development project revealed 25 economic activities involved, demonstrating challenges with comprehensive sustainable projects. The study acknowledges that the costs related to obtaining DNSH data may disadvantage small asset managers.

Beyond the DNSH criteria, the assessment of legacy green and sustainability bonds for the SC TSC compliance may also present some challenges. It is common in the green bond market that reporting of allocation and impact is made on a portfolio-basis and in an aggregated manner, and thus breakdowns per project type or technology do not easily allow a line-by-line SC assessment. The use of relative metrics is also very common, whereas the EU Taxonomy makes use of absolute intensity metrics for several activities[5]. Also, it may not be feasible to satisfy some of the SC TSC retrospectively[6].

Practical usability challenges

Related to Taxonomy disclosures:

- Risk of impairing GAR/GIR and SFDR disclosure assessments where data is not (or will not be) available.
- Challenge of accounting for the legacy green and sustainability bond market in GAR/GIR and SFDR as project-level DNSH data that would satisfy the granularity of the TSC is not available.

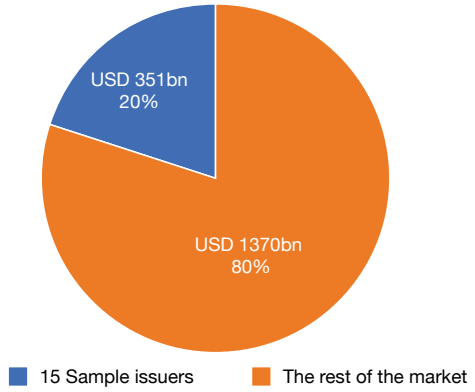
5 The analysis by the Climate Bonds Initiative in its "Post-issuance reporting in the green bond market", which provides a good overview of metrics used per green project categories based on the data in scope (see p.24 to 32), indicates that green bond issuers rely extensively on relative metrics (e.g. GHG saved/avoided/reduced), with around ten times more issuers using those as compared to the absolute metrics (generally favoured by the EU Taxonomy).

6 For instance, while impact reporting is common in the green bond market, not many issuers obtain external verification on their impact reporting. However, activities such as "manufacturing of other low carbon technologies" and "manufacturing of hydrogen" as well as "electricity generation from geothermal" require that quantified life cycle GHG emission savings are verified by an independent third party.

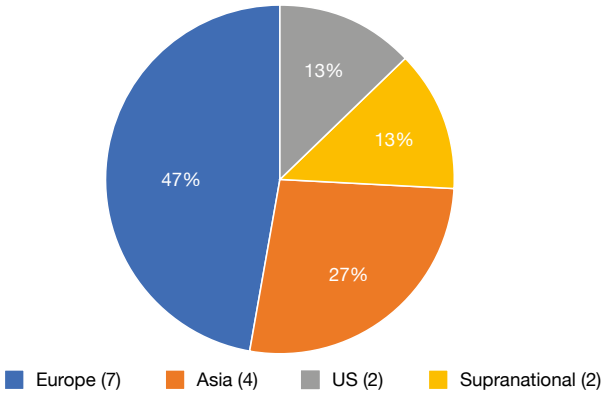
ICMA analysis of DNSH alignment in the green and sustainability bond market

As ICMA, we have also conducted an in-house analysis of the most recent green and sustainability bond-related documentation (frameworks, SPOs, allocation and impact reports) of 15 leading green and sustainability bond issuers (8 -located in Europe and 7 outside), distributed equally between SSAs, corporates, and financials. With this statistically significant sample (representing 20% of outstanding issuance and all key jurisdictions), our objective was to understand the extent to which existing public documentation could potentially allow a full EU Taxonomy assessment of existing investments in green and sustainability bonds from these issuers.

Outstanding volume of green and sustainability bonds of sample issuers vs total outstanding (USDbn)*



Geographic distribution of 15 sample issuers



**Data as obtained from the Environmental Finance database on 25 January 2022.*

In line with the GBP recommendation, most of these 15 issuers have in place issuer-level processes and policies to identify, manage, and mitigate their potential negative environmental and social impacts. Some issuers, especially corporates, also commit to report on ESG controversies related to their green projects and/or exclude those from green bond financing if such controversies occur. Issuers may also be applying a proportionality lens to their externality assessment, by looking at the stringency of environmental and social protection laws of the country of implementation or (in the case of banks) by adopting escalation mechanisms based on client profile and sector or financing size. Almost all these issuers otherwise have exclusion criteria in relation to, amongst other things, nuclear and fossil fuel activities. Other high-level and general trends we have observed were:

- In terms of sector, corporates have the broadest and most detailed environmental and social risk coverage also leveraging on their CSR policies.
- In terms of geography, Chinese issuers lag behind European and other issuers for disclosure of ESG management frameworks.
- The ESG risk management disclosure level may depend on the green project type. For instance, in case of refurbishment of existing buildings for energy efficiency, most environmental and social risks may be less relevant compared to new building construction projects.

Overall, regardless of how adequate these issuer-level frameworks may be for mitigating ESG risks related and relevant to their green projects, publicly available data (under their sustainable bond-related documentation) appears unlikely to allow a DNSH assessment sufficient to determine Taxonomy alignment.

2. Reliance on EU legislation and criteria in an international market

Unsurprisingly, and as required by the Taxonomy Regulation itself, the TSC relies by design on European legislation, as well as European labelling and certification schemes. The DNSH TSC heavily rely on the EU environmental legislation while EU-centric references are also embedded in the TSC for SC. This is not problematic in itself but becomes a real hurdle when assessing Taxonomy alignment because of the high degree of internationalisation of the activities of European companies. According to the EC, the EU is the world's main provider and destination of foreign direct investment, the existing stock of which amounted to almost EUR9 trillion at the end of 2019. Also, the cumulative flows from the EU to China have reached EUR140 billion at the end of 2020.

The Common Ground Taxonomy report released in November 2021 (which compared the EU and Chinese taxonomies) recognised the references to local or regional norms under these two taxonomies as a usability problem for international comparability. For instance, it stated that *"Energy Performance Certificates are the norm in the EU but are not available universally around the world"* (p.31), accepting that these would cause data unavailability. Facing the very same challenge under the PRI Study, an asset manager had to develop correspondence tables between the green building certification schemes widely used in the green bond market (e.g., LEED and BREEAM) and the SC TSC for the sector.

Relatedly, it is important to note that MS also reference international agreements that have not been adopted in all jurisdictions. As ICMA and the GBP Executive Committee indicated in its consultation response, for developed and emerging markets alike, not all third countries have signed up to the ILO Declaration on Fundamental Principles and Rights at Work, allow freedom of association or recognise collective bargaining. The Common Ground Taxonomy report also recognised the issue by stating that "while minimum safeguards are used in both taxonomies, these are not uniform across taxonomies and not easily comparable." (p.29).

Importantly, the EU Taxonomy is not transposable internationally. The SC criteria for many manufacturing activities are based on the *"average value of the top 10% most efficient installations in GHG performance"* in Europe according to the EU ETS data and expected to tighten every three years. In the past, ICMA and the GBP Executive Committee recommended that the Taxonomy reflect geographic conditions by setting country-specific thresholds for energy efficiency. Regions' differing starting points in decarbonisation and development needs are well recognised by the Paris Agreement and market-based frameworks. Pointing to the same issue, BusinessEurope called in February 2021 for additional clarification on how to assess activities for products and services in plants outside Europe where different metrics and decarbonisation perspectives apply.

In addition, it is striking that references to EU Directives under the TSC may cause a fragmented application of the EU Taxonomy even in the EU as transposition laws may differ depending on Member States. The UNEP FI & EBF study identified that connections with local regulations and reliance on local statistics make the application of the EU Taxonomy challenging, as demonstrated by a number of case studies which were inconclusive or unable to confirm alignment with the EU Taxonomy (see p.67).

Practical usability challenges

Related to Taxonomy disclosures:

- Hurdles for EU companies to disclose the Taxonomy alignment of their non-EU businesses.
- Risk of impairing GAR/GIR and SFDR disclosures for non-EU exposures of financial entities.
- Disadvantaging non-EU entities who may not be able to report Taxonomy alignment information to European investors.

Product-related:

- Risk of EU GBS not being used internationally, or even by EU companies in financing their assets and investments in third countries.

General:

- Risk of a fragmented TSC assessment, even in the EU, as alignment checks may differ depending on Member States.

3. Inconsistency in the use of estimates and third-party data

The need for estimates and third-party data in the assessment of alignment is partially recognised in the Taxonomy Regulation. This is illustrated in Recital 21 with reference to potential data gaps for non-NFRD entities (e.g., non-EU or small companies) which reads: *"there could be exceptional cases where financial market participants cannot reasonably obtain the relevant information to reliably determine the alignment with the technical screening criteria…In such exceptional cases, and only for those economic activities for which complete, reliable and timely information could not be obtained, financial market participants should be allowed to make complementary assessments and estimates on the basis of information from other sources."*

Nevertheless, Article 8 Delegated Regulation does not allow estimated Taxonomy-alignment to form part of the calculations for mandatory GAR/GIR reporting. It also remains unclear whether third-party sourced information can be the basis of mandatory GAR/GIR. Instead, as an interim solution, it excludes non-NFRD entities from the numerator of these ratios, at least until the 2024 review period[7]. Green and sustainability bonds from non-NFRD entities are an exception, but these can be included only if their issuers have disclosed the Taxonomy alignment information. In other words, financial entities cannot estimate the Taxonomy alignment of such green and sustainability bonds either.

We argue to the contrary that financial entities, and in the future issuers (under CSRD), will need to have the flexibility to use estimates and proxies whether from internal sources or from third parties. Assessing alignment will always require to some extent estimation and judgement, because of the structural complexity of the Taxonomy, the interpretable nature of some TSC, and the unlikelihood of all necessary data being available in every circumstance.

It is also important to note that access to data may differ depending on the type of financial entity. For instance, it can be expected that banks may request and obtain the required data more easily thanks to closer relationship and contact with their counterparties. For asset managers, the reliance on third-party data is much more pronounced.

Practical usability challenges

Related to Taxonomy disclosures:

- Risk of impairing GAR/GIR and SFDR disclosure assessments where data is not (or will not be) available.
- Challenge of accounting for the legacy green and sustainability bond market in GAR/GIR and SFDR, as data satisfying the granularity of the TSC is not available.

4. Absence of a proportionality lens for smaller companies and projects

Most TSC requirements, especially for the DNSH, apply to all entities and projects identically and without considering their size or their limited potential negative impact on the environment. This seems in contradiction with the Taxonomy Regulation itself which provides that TSC should take into account the scale of the economic activity (Art.19(h)).

Smaller companies, who may lack the in-house expertise, may become particularly disadvantaged, for instance due to assessing the DNSH TSC and related implementation challenges and consequent costs. As discussed in section V, the expansion of the Taxonomy disclosure via CSRD to 40.000 more companies in Europe will increase data availability for the financial sector but will essentially transfer many usability challenges without mitigating them.

Voicing these concerns, in December 2020, SGI Europe, which represents entities active in public interest services (e.g., waste management, energy, transport, housing, etc.), recommended that the principle of proportionality prevails in terms of company size, investment size, risk profile, etc. Similarly, ICMA and the GBP Executive Committee highlighted in their consultation response (October 2020) on the EU GBS that the need for an individual check of DNSH requirements for smaller green projects would bear high additional costs, making market conditions unattractive and hindering further growth for green financings for SMEs. A proportionate approach was therefore proposed where the DNSH requirements strictly apply (line by line) only to projects exceeding a certain size threshold.

7 Please note that Article 8 Delegated Regulation excludes other types of investments such as exposures to sovereigns and supranationals, which, from an investor point of view, reduces the comparability of portfolios. ICMA previously published a note on the exclusion of green and sustainability bonds sovereigns and supranational expressing its concerns.

The lack of proportionality is also a problem for small asset managers with less adequate resources in the context of GIR disclosure.

Practical usability challenges

Related to Taxonomy disclosures:

- Implementation challenges and cost issues with high risk of disadvantaging smaller companies and/or asset managers.

Product-related:

- Risk of increased costs causing market unattractiveness and less finance being available for green projects for SMEs.

5. Dynamic TSC for Substantial Contributions and the need for grandfathering

The SC TSC will, in many cases, change over time. 25% of mitigation activities of the Climate Delegated Act are indeed "transitional activities" for which environmental performance thresholds are expected to be reviewed and tighten at least every three years. This dynamic aspect of the Taxonomy is necessary and welcome, as it reflects the need to adjust the TSC to both technological and scientific developments, as well as to the European economy's actual progress towards its sustainability objectives. It creates, however, a problem for green and sustainability bonds that are either providing information on their Taxonomy alignment or are designed to be fully aligned with it, such as the future EU GBS.

Changing TSCs indeed mean that reported Taxonomy alignment information will need to be correspondingly updated which would likely have deleterious effects for the attractiveness and valuation of green and sustainability bonds acquired based among other on their degree of Taxonomy alignment. These indeed risk a form of Taxonomy "downgrade" when new TSCs are released that could lead to potential related sell-offs by investors. For future green bonds structured to receive the EU GBS label, the risk would be very significant as they could automatically lose it.

The remedy to this problem is to allow Taxonomy "grandfathering" (as illustrated in the EC's proposed EuGB legislation which provides however only for partial grandfathering). In other words, the Taxonomy information available at the time of the issuance of the bond would be considered and maintained for the life of the security. Investors would thereby be able to classify their Taxonomy related investments historically with the understanding that recent issuances would refer to the most up to date TSCs while older ones would align with earlier "vintages".

Practical usability challenges

Product-related:

- Unpredictability of the EU GBS designation for issuers and potential risk of forced sales by investors which may cause hesitation to issue or invest in EU GBS in the first place.

Related to Taxonomy disclosures:

- Unpredictability of EU GBS exposures as well as of Taxonomy alignment assessment of other green and sustainability bonds in the context of GAR/GIR and SFDR disclosures.

General:

- Risks related to market volatility.

6. The use of an economic activity-based classification system (NACE)

It has been highlighted by ICMA and the GBP Executive Committee in several consultations that the use of NACE, as an economic activity-based classification system, is not straightforward for assessing the Taxonomy alignment of green and sustainability use of proceeds bonds. The project assessment methodology of these bonds reflects a holistic and multidimensional approach towards sustainability and may also consider supply chain and end-use context. While some projects can be relatively simple, homogeneous in nature and easily linkable to the economic activity definitions of the Taxonomy Delegated Acts, some others (e.g., large-scale infrastructure and development projects) can be complicated for a Taxonomy alignment assessment.

Furthermore, a green or sustainable project may:

- consist of several different economic activities where individual project components may relate to the same or different environmental objectives and Delegated Acts of the Taxonomy;
- contribute to different environmental objectives at the same time; and,
- have social components.

The project case study under the Do No Significant Harm Handbook demonstrates how resource-intensive such conversion and assessment exercise could be. The case study revealed that a single development project located in the EU could lead to a large number of economic activities (25 in total), each of which require several more SC TSC and DNSH TSC and granular data points to be checked and complied with. In addition, we know that a green bond fund may be holding several green bonds, each of which may be financing several complex green projects such as those in the case study. The scale of the conversion and data extraction challenge cannot be overstated in these cases.

There are broader challenges with using the NACE system beyond the issue of project to activity conversion. The Common Ground Taxonomy revealed further limitations of an approach based on classification through economic codes under NACE when it states in a footnote on p.20 that: "*Although EU Taxonomy is based largely on NACE, there is no possibility of directly using single NACE codes in all cases. Many activities cut across several NACE codes, some NACE codes have multiple activities under them and some, such as building construction, are actually applicable across almost any NACE codes sector…Some mitigation activities have no NACE codes.*"

Practical usability challenges

Related to Taxonomy disclosures:

- Where data is not available for the legacy green and sustainability bonds, the impossibility to breakdown complex green projects into economic activities for the purposes of GAR/GIR and SFDR disclosures.
- Where data may be available, the highly resource intensive nature of such an exercise for complex green projects that involve various activities.
- Where NACE codes have multiple activities under them or activities have no NACE codes, classification of projects can be impossible or impractical.

General:

- Other problems related to the NACE's incompatibility with other classification systems for an international assessment.

V. Existing and emerging initiatives and solutions to usability challenges

It is encouraging, however, to see that several initiatives and solutions are emerging to address the usability challenges of the EU Taxonomy. The recommendations of the TEG remain very relevant. The EU co-legislators already propose solutions to some DNSH challenges under the EU sustainable finance regulations. On the market practice side, green bond issuers including the EC and external reviewers are experimenting with a more practical approach to the Taxonomy. Also, the initial methodology used by the IPSF for the Common Ground Taxonomy illustrates how international approaches can start by focusing on SC criteria. The EU PSF also has a dedicated workstream focusing on the Taxonomy's usability and data challenges.

1. The TEG recommendations on SC and DNSH TSC flexibility

In its Final Report of March 2020, the TEG recommended flexibility in DNSH assessment stating that "*For DNSH criteria that reflect legal requirements under EU regulations, it would be reasonable for Taxonomy users to assume these criteria have been met in the normal, lawful conduct of business, unless evidence to the contrary is demonstrated*" (p.32). Overall, the TEG also proposed a risk-based approach (with reference to ISO standards) for companies and issuers when applying the DNSH.

More concretely, in this report, the TEG recommended that in the absence of DNSH and MS compliance information, financial entities should conduct due diligence based on (see p. 47):

- The information gathered from credible sources (e.g., reports from international organisations, established market data providers, and credible civil society and media);
- The principle of proportionality considering, for instance, the size of the investee, context of its operations, severity of adverse impacts, etc.; and,
- The nature of the financial product.

In the context of the EU GBS, the TEG also brought forward in its Usability Guide (March 2020) two main recommendations to enhance the usability of the EU Taxonomy. Firstly, it recommended that there should be flexibility on the alignment with the TSC in certain exceptional situations. These would apply in connection with (i) the innovative or complex nature or the location of green projects or (ii) where specific TSC have not been developed for the green project in question. In such situations, allocations would still be made exclusively to green projects that: (i) substantially contribute to the Taxonomy's environmental objective(s); (ii) do not significantly harm others; and (iii) comply with the minimum safeguards. An external reviewer (an ESMA-registered and supervised or recognised entity under the proposed EuGB Regulation) would confirm the compliance of the issuance with these conditions. However, this recommendation did not make its way into the EC's EuGB proposal.

Secondly, the TEG had proposed a "process-based" approach on the DNSH TSC and MS, especially where these are qualitative. In that respect, the internal due diligence systems of issuers as well as project-related controversies could serve to showcase compliance with the DNSH and MS. Other proxies would be: (i) the existence of legally required environmental and/or social frameworks and permits for green projects; (ii) the existence of a risk analysis at project-level; (iii) and the existence of mitigation action plans if material ESG controversies occur.

More broadly, Annex 4 of the TEG Usability Report aims to provide practical examples of how to map green projects to relevant NACE codes. In the past, ICMA and the GBP Executive Committee also called for additional guidance and methodology for the application of NACE to green and sustainable projects. As discussed below, it will not be straightforward to use or disclose against the EU Taxonomy for complex green projects with multiple components, especially in the absence of more holistic guidance.

2. Proposed flexibility on the DNSH TSC under the EU Sustainable Finance Regulations

The Article 8 Delegated Regulation indicates that investments in entities that are not subject to the NFRD (e.g., non-EU entities or EU SMEs), but that provide such "*equivalent information*" voluntarily may be included in the mandatory GAR/GIR from 1 January 2025, subject to an affirmative decision taken during the 2024 review period. It seems further confirmed in the EC's FAQ document on Article 8 reporting (p.4) that the 2024 review period may provide a significant opportunity to address DNSH-related challenges (e.g. data unavailability and international applicability), as financial entities may be allowed to use estimate-based DNSH assessment for non-NFRD exposures, including non-EU ones.

Nevertheless, we understand that this flexibility, if allowed, will only cover DNSH TSC but not allow estimates or third-party sourced SC TSC information, at least under the current drafting. This means that the European focus of some of the SC TSC criteria as well as the lack of a location-based contextualisation of the Taxonomy's target levels (see above "*Reliance on EU legislation and criteria in an international market*") will continue to remain a problem for international exposures.

3. Future issuer and company reporting of Taxonomy information under CSRD

As indicated above, the NFRD which currently applies to around 11.000 companies will be replaced by the CSRD, an enhanced entity-level disclosure regime. The CSRD will introduce mandatory sustainability disclosures for around 50.000 companies (including listed SMEs) in the EU and thus extend the scope of Article 8 Taxonomy disclosures significantly[8]. This is expected to significantly increase the data availability for the financial sector for the purposes of GAR/GIR and SFDR disclosures.

Although it would be tempting to assume that the implementation of CSRD will largely resolve the concerns that we have identified above as Taxonomy disclosures will be extended to 40.000 more companies, this is not the case. Unfortunately, it is important to underline that CSRD will in effect be transferring to issuers and other companies many of the usability challenges and the related costs of producing Taxonomy alignment information without necessarily addressing the underlying issues. Specifically, issuers and entities in scope will:

- need to produce granular TSC information for both SC and DNSH criteria by adapting their internal processes and IT systems;
- require proportionality rules to calibrate the reporting practices to smaller companies;
- continue to face difficulties arising from the reliance on EU legislation and criteria where companies operate in multiple jurisdictions in both developed and emerging markets; and
- have to adapt the use of an economic activity-based classification system (NACE) for reporting of complex businesses.

4. Approach under the EU NGEU green bonds and other market practice to date

The NGEU Green Bond Framework of the EC adopts similar flexibility to the TEG's recommendations for the EU GBS. The EC's NGEU green bond issuance programme of up to EUR250 billion (by the end of 2026) will (re) finance Member States' Recovery and Resilience Plans and potentially make the Commission the largest issuer of green bonds. The eligibility of allocations to Member States is based on the EC's climate coefficients methodology as well as the DNSH Technical Guidance Notice C(2021).

Regarding the climate coefficients methodology, the EU's climate tracking methodology was historically based on the OECD Rio Markers[9], but has now been revised to incorporate certain elements from the EU Taxonomy where feasible. According to the methodology, activities that meet the TSC, as adapted from the Climate Delegated Act, are treated as dark green and get a full (100%) weighting for inclusion in the EU's green pool. This treatment also acts as an incentive for MS to be ambitious and align with the adapted TSC as much as possible. Nevertheless, the methodology remains open to activities which may have

8 Readers may consult ICMA's "Sustainability Disclosure Regime of the European Union" for a brief comparison of the NFRD and CSRD (p.7-8).
9 The OECD Rio Markers have in fact influenced the climate budget tagging of several sovereigns. For a brief overview, see ICMA's Overview and Recommendations for Sustainable Finance Taxonomies, p. 17-18.

no TSC reference or alignment, as it is acknowledged that some of these can still make a substantive contribution to the Taxonomy's objectives. Furthermore, Member States are allowed to propose climate coefficients to the EC in cases where a reform or measure to be financed has not been covered by the current scope of the coefficient methodology (e.g., innovative activities).

Secondly, Member States are not required to comply with the DNSH TSC of the Climate Delegated Act. While all Member State measures to be financed by NGEU green bonds will need to satisfy the DNSH in principle, the Technical Guidance adopts a proportional approach as the DNSH check against each environmental objective can take a "simplified form". This is the case, for instance, if a measure has no or insignificant foreseeable impacts, where a minimum explanation would suffice to satisfy the DNSH condition. Furthermore, even in the case of a "substantive DNSH assessment", the Technical Guidance establishes a non-exhaustive list of supporting evidence upon which Member States can rely. The list includes the following items as cross-cutting evidence of DNSH compliance: (i) compliance with environmental legislation and presence of permits/authorisations; (ii) implementation of recognised environmental management systems (EMAS or ISO14001 or equivalent); (iii) conduct of climate and environmental proofing in infrastructure investments. The Technical Guidance has also useful case studies on how to implement the DNSH assessment accordingly.

Emerging practice from other sustainable bond issuers also seems to improve the Taxonomy's usability. While only a handful of issuers have published green bond frameworks which aim to align with the EU Taxonomy, looking at those, we have seen that the TSC metrics and thresholds are typically focused on the SC component. For the DNSH and MS, external reviewers particularly consider the adequacy of issuer-level policies and processes, environmental and social laws and regulations of the country, issuer's initiatives to address specific environmental risks or implementation of international standards (e.g., ISO), past conduct of environmental impact assessment, and past controversies as proof or proxy. Examples of some initial assessment approaches are the following:

- A major external reviewer consistently states in its framework assessments that "*Alignment … is usually based on the specific criteria contained in the issuer's Framework, and may in many cases (especially DNSH criteria) also be based on management systems and processes and/or regulatory compliance. To assess alignment with the EU Taxonomy's Minimum Safeguards [the external reviewer] has conducted an assessment of policies, management systems and processes applicable to the use of proceeds, as well as examining the regulatory context in the geographical location in which the issuer will finance activities and projects.*"
- Implementing a proportionality approach, an external reviewer assumed the requirement of a "water use and protection management plan developed in consultation with stakeholders" as de-facto satisfied based on the fact that the issuer does not operate in regions with severe water stress or scarcity and complies with all national laws and regulations.
- On the DNSH TSC for climate change adaptation, external reviewers highlight national or regional adaptation initiatives or legislation that also applies to the projects and operations of the issuer. We have also seen the implementation of the TCFD recommendations by a company being used as a proxy to address physical climate risks.
- Another external reviewer conducting the MS analysis referred to the fact that the issuer is operating in France, which ratified in 2016 the Protocol of the 1930 ILO Forced Labour Convention (no.29) and that "*it is a criminal offence for companies to engage in activities that breach people's rights, equality laws, environmental laws, or social, health and safety laws.*" It also referred to the issuer's contracts with its suppliers and contractors where it imposes "social clauses".

Furthermore, the 2021 edition of the Green Bond Principles encourages issuers to provide information, if relevant, on the alignment of green projects with official or market-based taxonomies. This latest addition aims to generate voluntary Taxonomy data from issuers that, among other things, would help with the implementation of GAR/GIR and SFDR disclosures by financial entities.

5. The approach in the Common Ground Taxonomy

The Common Ground Taxonomy ("CGT") adopts a pragmatic approach in an international context. In November 2021, the International Platform on Sustainable Finance published its long-awaited Report on a Common Ground Taxonomy, which provides a detailed table for 80 climate change mitigation activities that resulted from a comparison between the EU and China taxonomies. Having recognised the practical challenges and the different approaches to DNSH and MS between these two jurisdictions, the initial comparison methodology of the CGT only focuses on the SC criteria as a starting point.

6. The work of the EU Platform on Sustainable Finance

The EU Platform on Sustainable Finance has a dedicated workstream focused on the usability and data challenges related to the Taxonomy. In December 2021, the EU Platform released two set of documents to provide additional guidance on the implementation of the entity-level Taxonomy disclosures: (i) Platform considerations on voluntary information as a part of Taxonomy-eligibility Reporting and (ii) NACE Alternate Classification Mapping. The former, while not being an official document endorsed by the EC, supplements the EC's official non-binding FAQ documents on the implementation of Article 8 Delegated Regulation and provides additional guidance on voluntary disclosures.

VI. Recommendations

Taxonomy usability issues are highly topical for existing and future reporting under SFDR and CSRD, as well as the upcoming EuGB regulation. In this context and considering the challenges identified in this paper, we are making five key recommendations to EU co-legislators and regulators. The first three recommendations are designed to address broad usability concerns for both product alignment and sustainable reporting, while the last two address issues that are more specific to assessing the Taxonomy alignment of green and sustainability bonds.

1. Allow flexibility on alignment with the DNSH and MS in all cases

We recommend that the application of the DNSH and MS in all cases (NFRD/CSRD disclosures, GAR/GIR and SFDR disclosures, EU GBS) is supported with guidance on flexibility that:

- allows as proxies issuer-level controversy analysis and ESG risk processes and mechanisms with criteria such as (i) the level of disclosure on ESG practices, (ii) the disclosure of information on risk coverage, and (iii) the pertinence of the information provided by the issuer framework to the relevant DNSH TSC;
- allows alignment with the DNSH and MS at a principle and outcome level per related environmental objective rather than with granularity, and;
- integrates proportionality to avoid excessive assessment and implementation challenges by businesses and/or financial entities in the context of Taxonomy disclosures.

2. Enable TSC adaptation to non-EU jurisdictions

A location-based contextualisation of the application of TSC for SC and DNSH is needed. This would be in line with the Paris Agreement which recognises the regional differences and development needs as well as with existing market frameworks. ICMA has previously recommended that the Taxonomy reflect geographic conditions by setting country-specific thresholds for example for energy efficiency. For example, SC criteria of "the average value of the top 10% most efficient installations in GHG performance", which applies to many manufacturing activities, could be reviewed on a country-specific or regional basis with appropriate calibration. This will be critical to reflect the global challenge presented by climate change and environmental degradation.

3. Allow estimates and third-party data based on a common methodology

We recommend that the use of estimates and third-party sourced data be allowed when Taxonomy assessments cannot be otherwise produced or obtained. This would be consistent with the Taxonomy Regulation's Recital 21 which recognises that investors should be allowed to make complementary assessments and estimates on the basis of information from other sources in exceptional cases where data gaps prevail (e.g., non-NFRD exposures).

We recognise, however, that potential inconsistent estimation methodologies may lead to fragmented practices that could affect the reliability of Taxonomy alignment assessments. We therefore recommend that guidelines for a common methodology be developed in consultation with all concerned parties with a focus on practicality and cost-efficient usability.

4. Simplify NACE classification of complex green and sustainability projects

A conversion methodology for complex projects funded by green and sustainability bonds to economic activities under NACE classifications is needed. We would recommend, for example, the adoption of a "lead activity(ies)" concept. This would allow for flexibility for the rest of the identified activities based on the alignment of the lead activity(ies). Supporting parameters could be:

- The issuer's primary green and sustainability objectives for the project;
- The amounts allocated (or committed) to the underlying components of the project and/or their cost; and
- The focus of the impact reporting and metrics applied to the project and its components by the issuer.

5. Grandfather the legacy green bond market for GAR/GIR and the SFDR disclosures

If green and sustainability bond issuances had completely stopped on 2 December 2021, there would still be on 1 January 2024 (when both GAR and GIR and the SFDR disclosures on alignment would be applicable) 3477 outstanding green and sustainability bonds totalling USD1.48 trillion[10] and thus representing a very substantial contribution to the financing of sustainable projects and objectives. This illustrates the importance of finding a way to incorporate the existing green and sustainability bond market under Taxonomy disclosures, especially as the market has not stopped issuing and continues to grow rapidly.

As sufficiently granular information to assess the Taxonomy alignment for these legacy green and sustainability securities is not available, we recommend that a method be agreed to grandfather them. This can be achieved by:

- Either recognising the degree of Taxonomy alignment of legacy green and sustainability bonds in a wholesale manner;
- Or, by providing or endorsing a flexible and common methodology for the purposes of GAR/GIR and SFDR disclosures.

10 Based on Environmental Finance data (obtained on 2 December 2021).

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