Green Technical Advisory Group

Green Finance Institute

Getting KPIs Right: Implementing an effective reporting regime for the UK Green Taxonomy

August 2023

Contents

Executive Summary

The UK Taxonomy aims to direct investments towards green activities, encouraging businesses to adopt greener business models to increase taxonomy alignment over time. Additionally, the taxonomy will enhance transparency and comparability in sustainability practices among companies, credit institutions, and investors, helping address the issue of greenwashing and emergent reports of greenhushing.

The UK Government's latest Green Finance Strategy[1], includes a commitment to mandate company disclosures in line with the Taxonomy, after a voluntary disclosure period of at least two reporting years.

Sequencing of reporting requirements is a key matter to get right if the UK Green Taxonomy is to be both useful and usable. GTAG believes that corporates should report ahead of financial institutions, as financial institutions are dependent on information disclosed by corporate clients and investee companies for their own reporting. Beyond sequencing, this paper focuses primarily on the Key Performance Indicators (KPIs) that should be used in taxonomy reporting.

The Green Technical Advisory Group (GTAG) has identified challenges with European taxonomy reporting KPIs for both financial and non-financial companies and offers recommendations to address these issues. The UK has not adopted Articles 5, 6, and 8[2] of the EU Taxonomy Regulation into UK law, which presents an opportunity to design a more effective reporting framework informed by the EU's experiences with usability issues. A summary of GTAG's recommendations is set out on the following pages.

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1 HM Government (2023) Mobilising Green Investment: 2023 Green Finance Strategy. Available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1149690/mobilising-green-investment-2023-green-finance-strategy.pdf. The UK Government's Greening Finance: A Roadmap to Sustainable Finance introduced Sustainability Disclosure Requirements (SDR) alongside the UK Green Taxonomy framework. This new regime streamlines existing reporting, adds environmental impact disclosures, and deploys the UK Green Taxonomy to generate SDR disclosures in annual reports or other relevant publications. The application of the UK Green Taxonomy will be determined by the SDR framework, which will outline principles for taxonomy-aligned disclosures. It aims to provide an integrated disclosure framework for UK companies, asset managers and asset owners that builds on and incorporates existing and upcoming standards, such as the International Sustainability Standards Board (ISSB) standards and TCFD disclosure requirements under the Listing Rules and Companies Act 2006.

2 Article 8 of the Taxonomy Regulation requires financial and non-financial companies to report on key performance indicators (KPIs) to increase transparency and prevent greenwashing. Article 5 and 6 of the Taxonomy Regulation set out fund-level reporting requirements.

Recommendations

Non-Financial Company Recommendations:

1. **Keep the requirements articulated in Article 8 of the EU's Taxonomy Regulation[3] for firms to report on their turnover and capital expenditure (capex) relative to the taxonomy, as primary indicators of green performance.** Turnover offers insights into a company's current sustainability performance, while capex demonstrates their commitment to align with the taxonomy in the medium- to long-term. These indicators can guide investor decision-making and promote sustainable business practices.

2. **Align with the EU requirement[4] for operational expenditure (opex) to be optional, limiting mandatory reporting requirements to turnover and capex.** Whilst the EU approach requires an assessment of materiality against opex disclosure, GTAG recommend that opex should be fully optional without requiring a materiality assessment. This approach reduces the burden on companies while still allowing them to voluntarily disclose opex information if they believe it is beneficial. By prioritising turnover and capex, investors can gain valuable insights into both present and future sustainability performance without overwhelming companies with excessive reporting obligations.

3. **For meaningful and comparable reporting across different accounting frameworks, clear and consistent definitions for turnover, capex, and opex KPIs should be provided.** GTAG recommend that His Majesty's Government (HMG) should consult early on these definitions, potentially in the autumn 2023 consultation or future consultations around Sustainability Disclosure Requirements. This is crucial as 'turnover' and 'revenue' carry different meanings in legal and accounting standards[5].

4. **Broaden the scope of capex category C as set out in the EU's Disclosures Delegated Act for the Taxonomy Regulation[6] to encompass additional environmental objectives, enabling more companies to receive credit for their positive contributions to sustainability.** To achieve this expansion, HMG should consider developing a universal set of Do No Significant Harm (DNSH) indicators that can be applied to various activities and sectors not currently covered by the UK Green Taxonomy[7]. This approach will encourage a wider range of companies to invest in and implement sustainable practices, further promoting environmentally responsible business activities.

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[3] Article 8 was expanded on in the Disclosures Delegated Act on 6th July 2021. The UK did not onshore the EU Taxonomy Delegated Acts.

[4] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32021R2178 Annex I Section 1.1.3.2 Where the operational expenditure is not material for the business model of non-financial undertakings, those undertakings shall:
  a) be exempted from the calculation of the numerator of the Opex KPI in accordance with point 1.1.3.2 and disclose that numerator as being equal to zero;
  b) disclose the total value of the Opex denominator calculated in accordance with point 1.1.3.1;
  c) explain the absence of materiality of operational expenditure in their business model."

[5] The EU Taxonomy uses the term 'turnover' consistently throughout. That said, the definition in Annex 1, paragraph 1.1.1 of the Disclosures Delegated Act does provide some ambiguity. The term 'net turnover', as per Directive 2013/34/EU, is aligned with the Companies Act definition (s474), which describes it as "amounts derived from the sale of products and the provisions of services net of sales rebates, value added tax, and other taxes directly linked to turnover". However, the annex indicates that turnover should cover the 'revenue' as set out in paragraph 82(a) of International Accounting Standards (IAS) 1. "Revenue" under IFRS is defined more broadly as "income arising in the course of an entity's ordinary activities" and may therefore include items which would not fall within the definition of "turnover". The UK could define a clear and unified term for reporting to avoid any confusion or inconsistencies. This could either be "turnover" as defined in the Companies Act or "revenue" as defined under IFRS. Alternatively, the UK could offer companies the choice of using either turnover as defined in the Companies Act or revenue as defined under IFRS, depending on the financial reporting framework that the company chooses and the resultant presentation of "revenue" or "turnover" in the income statement.

[6] The Disclosures Delegated Act specifies the content and presentation of disclosures required in accordance with Article 8 of the Taxonomy Regulation. Capex C is defined by the EU as capital expenditures related to the acquisition of production from Taxonomy-eligible economic activities and individual measures that enable the target activities to become low-carbon or lead to greenhouse gas reductions.

[7] GTAG has provided detailed advice on how to streamline and increase usability of Do No Significant Harm (DNSH), and the development of any such indicators should be done in conjunction with the detailed recommendations set out in that research paper. In the EU, the DNSH test requires the mandatory use of Principle Adverse Impact (PAI) indicators and the EU PSF in their Data and Usability paper noted that the European Commission has mandated the European supervisory authorities (ESAs) to review and revise the Sustainable Finance Disclosure Regulation (SFDR) Regulatory Technical Standards (RTS) with respect to the PAI indicators.

Credit Institution Recommendations:

5. **Reassess the approach to Green Asset Ratio (GAR). GTAG recommend one of the following two approaches:**

   a. **Exclude non-relevant activities/ investments from the GAR calculation.** To maintain consistency and fairness in calculating the percentage alignment of a bank's balance sheet, any activity or investment that cannot be assessed under the UK Green Taxonomy should be excluded from both the numerator and the denominator[8]. This ensures that the ratio more accurately represents the proportion of green activities in the bank's balance sheet. A list of included and excluded assets should be created by HM government[9].

   b. **Restrict GAR calculations to the bank's lending book only.** To address concerns about the GAR's comparability and potential bias towards specific banking models, such as retail banking over investment banking, the GAR should be calculated based solely on the bank's lending book. This limitation ensures a more accurate and equitable representation of a bank's green activities and prevents undue favouritism.

6. **Government should consider setting up a working group dedicated to designing Technical Screening Criteria (TSC) for financial services that capture and measure incentive schemes promoting green behaviour[10].** This approach could either complement a slimmed down GAR or could fully replace it, depending on the recommendations from the working group. Examples of such incentive schemes include transition-plan lending activities, mortgage incentive schemes for energy efficiency, or green advisory services. The Financial Services TSC could then evaluate the proportion of a bank's income generated from these green incentive schemes, ensuring a more comprehensive assessment of their contributions to the transition.

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[8] For instance, sovereign exposure and derivatives are included in the denominator but excluded from the numerator of the GAR calculation in the EU.
[9] Or this list could be kept by another single authority as per recommendation 5 in GTAG's DNSH paper.
[10] This aligns with GTAG's recommendation in the Extended Taxonomy paper.

Investor Recommendations:

7. **Report at the fund level and disclose taxonomy components for each fund instead of using the Green Investment Ratio (GIR) at the entity level.** Recognising that a significant proportion of asset managers operate in an agent role and are still bound by existing investment guidelines which limit the percentage of green taxonomy-aligned investments they can direct, a shift to the fund level provides a clearer and more accurate representation of how much of a client's portfolio aligns with the UK Green Taxonomy. This specificity in reporting could also instigate clients to express more clearly their preference for UK green taxonomy-aligned investments. This recommendation is based on the premise that the clients, not the shareholders of the investment firm, are the true driving force for change in investment behaviour. As such, this approach will empower clients to be more aware of, and consequently more proactive about their investments' alignment with the UK Green Taxonomy. GTAG also recommend that this fund reporting should be done for all funds, regardless of whether they are labelled as ESG or not[11], to allow for better comparability and reduce the likelihood of greenwashing.

8. **Apply fund-level reporting to all funds, irrespective of ESG labelling.** By requiring fund-level reporting for all funds, regardless of their ESG designation, it becomes easier to compare fund performance, reduces the risk of greenwashing, and levels the playing field in terms of data costs[12] for sustainable versus non-designated financial products.

9. **Differentiate between insurers' proprietary investments and their unit-linked or with-profit businesses.** GTAG recommend that insurers' own-account investments, made to offset the liabilities accrued from their underwriting activities, be reported at the entity level. On the other hand, their unit-linked or with-profit businesses, where the policyholders assume the investment risks and rewards, should be reported at the product level, as the insurance company are operating in an agent role.

10. **Explore TSC for financial services related to insurance premium discounts, adaptation measures, and financing activities for mitigation or adaptation via the aforementioned working group.** The establishment of additional screening criteria for the insurance sector will better encapsulate the breadth of their activities and will encourage firms to integrate sustainability considerations into their operations, both on the liability and asset sides of the balance sheet.

[11] In the EU Taxonomy Regulation articles 5 & 6 product-level disclosures are limited to funds that either pursue sustainable objectives or incorporate sustainable characteristics (as per SFDR articles 8 and 9 eligible products).

[12] This has sometimes led to higher management fees (see Figure 2).

These recommendations build upon high level recommendations made in previous GTAG papers:

- **The SDR framework should factor in existing industry feedback on the EU Taxonomy KPIs when developing UK equivalents, to improve their usability, comparability and usefulness[13]:** The process must also set clear, consistent definitions for these KPIs to ensure meaningful and comparable reporting across various accounting frameworks. Technical experts at the Financial Conduct Authority (FCA) should lead this work. GTAG provided further advice on the KPIs in a separate report.

- **The international applicability of the taxonomy KPIs (including those for financial institutions) must be considered[14]:** The UK Government should consult on including voluntary reporting on foreign assets and activities[15], which could support use of the framework beyond the UK's borders and increase the quality of available information while limiting the burden on businesses. Additionally, the costs and benefits of expanding KPIs to data provided on a voluntary basis by entities not covered by SDR should be considered.

- **Provide guidance on how companies and financial services firms can report on their performance abroad when using key performance indicators (KPIs) under the future UK reporting regime[16]:** GTAG suggests that it may be beneficial to deviate from the EU8 and allow companies to include international activities in some of their UK KPI reporting. It is important to note that the voluntary inclusion of global performance should be in addition to UK specific performance, allowing for a clear understanding of both global and domestic components of performance. There should also be the option to report on both their alignment and eligibility figures for specific jurisdictions, to further enhance this understanding.

[13] https://www.greenfinanceinstitute.co.uk/wp-content/uploads/2023/08/GTAG-Final-Report-on-Extended-Taxonomy.pdf

[14] https://www.greenfinanceinstitute.co.uk/wp-content/uploads/2023/08/GTAG-Final-Report-on-Extended-Taxonomy.pdf

[15] UK can only regulate for UK assets, but allowing for extra-territorial reporting is useful for global targets.

[16] https://www.greenfinanceinstitute.co.uk/wp-content/uploads/2023/02/GFI-GTAG-INTERNATIONAL-INTEROPERABILITY-REPORT.pdf)

Introduction

Introduction

In this paper GTAG provides recommendations for the implementation of a best-in-class reporting regime that effectively serves the needs of users, maximises KPI usefulness, and guides capital allocation towards sustainable activities while tackling greenwashing. The goal of these recommendations is to create a reporting framework that promotes a sustainable economy and enables stakeholders to better evaluate and manage their environmental risks and opportunities, providing a more accurate and complete picture of a reporting entity's alignment with sustainable objectives.

Key Design Points

- **Learning from International Experiences:** The UK, as followers, can benefit from the experiences of other countries, learning from their successes and shortcomings in KPI reporting. This will enable the UK to design a best-in-class reporting regime that effectively serves the needs of users.

- **A First Principles Approach:** GTAG approached the issue of KPI reporting from first principles, focusing on designing KPIs that maximise their usefulness for users. This involves examining the EU's approach and assessing its suitability for the UK, while also considering alternative options.

- **Contributing to Decision-making on Corporate Reporting Rules:** While the UK government is in the process of operationalising one of the routes for financial services taxonomy reporting[17], it has yet to decide on corporate reporting rules. GTAG's work contributes to this decision-making process.

- **Remembering the Taxonomy's Ultimate Goals:** It is essential to keep in mind the primary objectives of the taxonomy: mobilising capital towards sustainable economic activities to facilitate achievement of the UK's transition to a sustainable economy; to track financial flows and progress; and to promote market integrity and avoid greenwashing. This focus will ensure that the KPI reporting framework promotes a sustainable economy and enables stakeholders to better evaluate and manage their environmental risks and opportunities.

- **Moving Beyond a Debt-focused Approach:** Focusing solely on debt instruments is outdated and ineffective in achieving the taxonomy objectives. A more comprehensive approach should be explored, which encompasses broader aspects of a company's environmental performance. This will provide a more accurate and complete picture of a company's alignment with sustainable objectives.

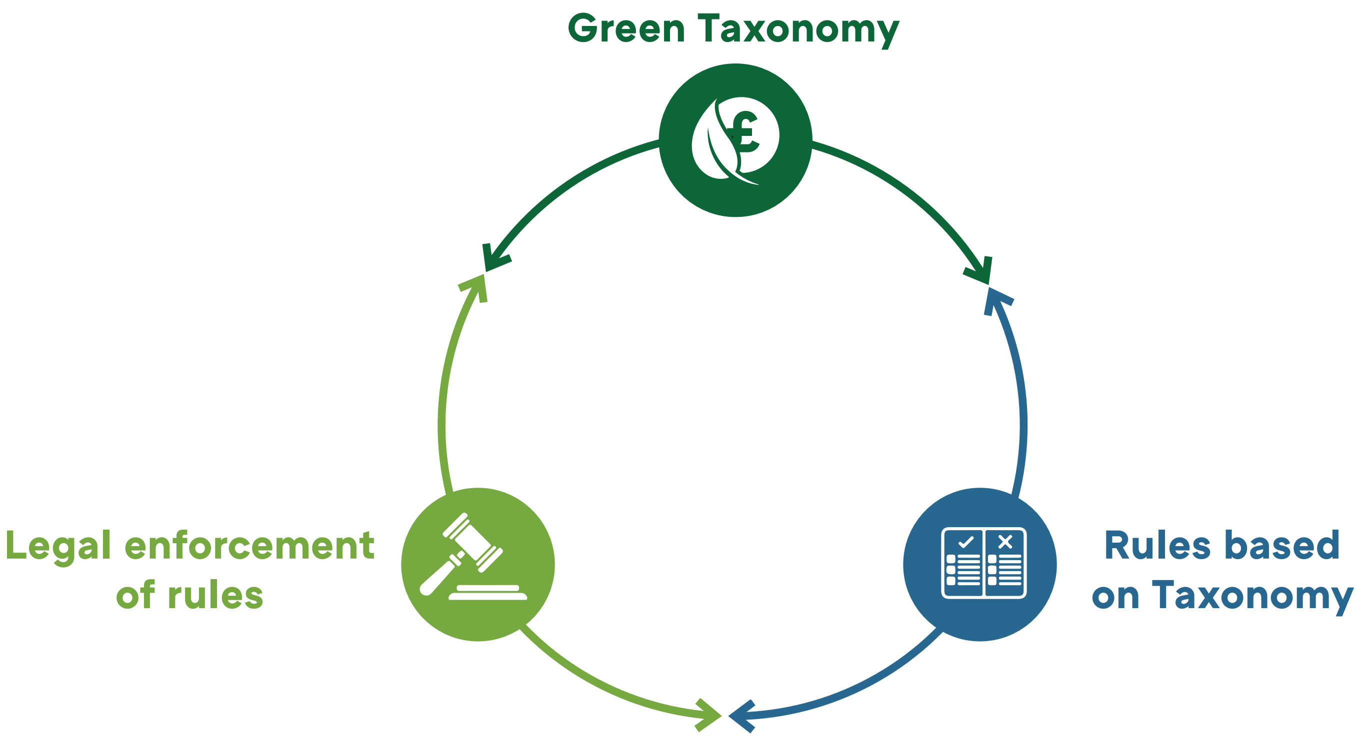
- **Learning from the EU's Prescriptive Reporting Regime:** The EU has implemented a prescriptive reporting regime, which has faced criticism for falling short of achieving its stated objectives. The UK can learn from their experience and improve upon it, adopting a reporting framework similar to the EU's while addressing its usability challenges and ensuring that the KPIs effectively guide capital towards environmentally sustainable initiatives.

[17] This is part of FCA's Sustainability Disclosure Requirements (SDR) and investment labelling work, which refers to reporting allocation of funds to "taxonomy-aligned sustainable investments" under certain labels, in its consultation. The FCA will publish a Policy Statement in response to the consultation in Q4 2023.

Role of disclosures and their interactions with the taxonomy

Disclosures are essential in translating taxonomies into practical applications and legal and regulatory measures are needed to integrate them into the capital markets reporting landscape (see Figure 1). These disclosure requirements can encompass mandatory or voluntary reporting obligations for asset managers, facilitating green bond issuances, and aiding green labelling to combat greenwashing. Taxonomies, along with their corresponding reporting system, can also significantly contribute to shaping transition plans, by providing credible, robust indicators of a company's sustainability - and monitoring alignment over time to demonstrate progress towards targets.

Figure 1: **Relationship between taxonomies and their application**[18]



A Taxonomy's Technical Screening Criteria (TSC) are thus most effective when complemented by robust reporting rules and Key Performance Indicators (KPIs). KPI reporting is crucial for business management, offering insights into an organisation's performance and progress towards achieving strategic goals. In the context of a taxonomy, **KPI reporting provides a systematic and structured method for measuring, tracking, and evaluating the success of various processes and initiatives using common terminology and an accepted definition of 'sustainable'.**

Taxonomy disclosures promote the transition to a sustainable economy by enhancing transparency and consistency in environmental reporting across non-financial companies, banks, and investors. By adhering to a standardised tool, like a taxonomy, these stakeholders can better evaluate and manage their environmental risks and opportunities.

The growing emphasis on sustainability and the need for transparent, standardised information on environmental performance necessitates taxonomy disclosures for assessing the alignment of companies, banks, and investors with environmental objectives.

[18] https://www.greenfinanceinstitute.co.uk/wp-content/uploads/2023/02/GFI-GTAG-INTERNATIONAL-INTEROPERABILITY-REPORT.pdf

Design Considerations and UK Opportunity

Design Considerations and UK Opportunity

The UK has an opportunity, as it has not adopted Article 8[19] of the EU Taxonomy Regulation, to design a best-in-class reporting regime which leverages the UK Taxonomy to provide a comprehensive understanding of the UK economy's activities. GTAG analysed the EU's approach to KPI reporting and evaluated whether the adopted KPIs are suitable for the UK - or whether alternative options should be considered. The analysis focused on non-financial company reporting obligations, credit institutions (banks), and investors (asset managers, insurance providers, and pension funds).

Structural Considerations

Taxonomies often vary in structure and application, which influences the choice of reporting systems that accompany them. **There are two main approaches to taxonomy reporting: a simplified regime for green bond issuance and a more comprehensive regime covering both financial and non-financial reporting.**

The simplified reporting approach primarily offers guidance for issuing green finance instruments, such as bonds, loans, and structured products. **Initially, early taxonomies like the Climate Bonds Initiative (CBI) and China's Green Bond Endorsed Project Catalogue developed voluntary guidelines for the green bond market. However, the taxonomy concept has evolved from a voluntary, market-driven tool to one that can be applied to a wide range of activities by companies and financial product issuers.** Going back to first principles when considering how to design a reporting regime for the UK, the first option GTAG discussed involved restricting reporting to debt capital markets, focusing on the use of proceeds for debt instruments, rather than turnover, capex, opex, or other KPIs. This approach primarily concentrates on injecting new capital into the net zero economy, treating the taxonomy as a tool for the debt market, with no requirements for reporting at the company level.

Restricting taxonomy reporting to debt capital markets has both advantages and drawbacks. On the upside, this approach could offer a clear connection between funds raised and the green projects they finance. This targeted reporting can offer investors greater transparency and accountability, which could make it easier for them to evaluate the environmental impact of their investments. It could also simplify reporting and reduce the burden on companies. **On the downside, this narrow scope would not capture a company's full sustainability efforts related to their operations. By focusing only on debt instruments, the broader context of a company's turnover, capex, and opex would be overlooked and would likely lead to greenwashing, undermining sustainable investments.**

The second option involves adopting a framework similar to the EU's and adjusting as needed. **GTAG explored various opportunities to improve upon the EU framework,** for example dropping opex from company reporting, focusing only on the loan book for banks, and requiring fund-level reporting without obligations at the asset manager entity level.

A more comprehensive regime allows governments to assess the proportion of green products and companies within their financial markets and overall economies. This information enables regulators and governments to track the effectiveness of taxonomies in channelling financial resources towards environmental priorities. In comparison, simplified green bond disclosure regimes might not be adequate for measuring the climate-aligned economy beyond green financial instrument issuers.

After considering the advantages and drawbacks of restricting taxonomy reporting to debt capital markets, **GTAG concluded that adopting a more comprehensive framework would be the best course of action.**

[19] Article 8 in the EU requires financial and non-financial companies to report on taxonomy KPIs.

EU Reporting Challenges

The EU Taxonomy distinguishes between financial and non-financial companies, with each required to report both their taxonomy-eligible and non-taxonomy eligible portions of their economic activities. Non-financial companies disclose these shares in terms of turnover, investment (capex), and operating expenses (opex), while financial companies report the shares of exposures in their total assets.

The EU Taxonomy reporting rules have become more complex than those recommended by the Technical Expert Group (TEG) back in 2020, causing difficulties for reporting entities (see Table 1 below). The TEG had aimed for clear and user-friendly guidelines, but regulatory changes made the framework more intricate. This deviation resulted in confusion and misreporting among firms struggling to comply with the extensive EU Taxonomy requirements.

The below table sets out what a reporting regime should hope to achieve for companies, banks, and investors. GTAG then looked at the original TEG recommendations in the EU, and compared these to the final form reporting regime, before then assessing whether the objectives were achieved. Table 2 then sets out GTAG's recommendations to better achieve these objectives in the UK.

Table 1: **Comparison of TEG Recommendations vs. EU Final Form Reporting Regime for Achieving Sustainability Objectives**

Objective	March 2021 TEG Paper (what TEG recommended this should look like)	Objective Achieved?	October 2022 PSF Paper (what the EU final form looked like)	Objective Achieved?
Companies: Trigger changes in business models to increase taxonomy alignment over time whilst improving transparency and comparability of the sustainability activities of companies.	Current performance indicator **(turnover)** Forward performance indicator **(capex + opex)**	✔	Primary KPIs of Turnover, Capex and Opex carry some implementation challenges - notably in their alignment to accounting principles. These have had to be cleared up in supplementary guidance by the European Commission.	✔
Banks: Encourage and incentivise financial actors to drive capital towards green activities.	Report the **loan book**	✔	Report the whole balance sheet **(Green Asset Ratio)**	✘
Investors: Channel investments towards green activities and curb greenwashing. Ensure investors are able to see clearly both the risks and impacts associated with their investments.	Report on **turnover** and **capex of investee companies**	✘	**Green Investment Ratio**	✘

Table 2: **GTAG's Recommendations for Achieving UK's Sustainability Reporting Objectives**

Objective	UK Recommendation
Companies: Trigger changes in business models to increase taxonomy alignment over time whilst improving transparency and comparability of the sustainability activities of companies.	• Undue complexity makes transparency and comparability difficult. • Ensure that accounting principles to the treatment of turnover and capex are applied (e.g., International Financial Reporting Standards (IFRS)). • Ensure the treatment of joint ventures, sub-contracted business types, and other edge cases are well clarified. • Remove the mitigation-only application of capex category c.
Banks: Encourage and incentivise financial actors to drive capital towards green activities.	• Reconsider GAR, as in its current form in the EU regime it is not a true reflection of the bank's green activities, favouring certain bank structures over others. Preference to limit GAR to banking/lending book only and remove application to trading book and fees & commissions (in line with PSF 2022 guidance). • Consider application of the UK Taxonomy GAR reporting to governments, supranational, central banks, and SME lending. • Consider applying TSC for financial services to capture and measure incentive schemes, giving credit for mitigation / adaptation efforts by the company to whom they are lending – thus encourage behaviour aligned to net zero e.g., transition-plan lending activities, green mortgages, or mortgage incentive schemes on energy efficiency.
Investors: Channel investments towards green activities and curb greenwashing. Ensure investors are able to see clearly both the risks and impacts associated with their investments.	• Reconsider GIR as it applies to activities conducted in agency capacity. Suggestion to report on own account activities or based on the proportion of green investments offered as a percentage of total. Green investments would need to be defined either via SDR or directly from Taxonomy alignment of investments contained. • Preference to report at the fund-level, under the FCA's mandate, the taxonomy alignment of what is being invested in, explaining both the quality of current and future (Taxonomy-aligned) performance of all funds, irrespective of labelling. Evidence of the taxonomy components of funds will act as a useful narrative to provide to asset owners.

Non-Financial Companies

Transparent and consistent reporting on sustainability performance is crucial for stakeholders to assess the environmental impact of organisations. Taxonomy disclosures support the transition to more sustainable business practices by providing a standardised framework for reporting environmental performance, which allows companies to assess and communicate their contributions to climate change mitigation, adaptation, and other environmental goals.

In the EU, reporting of eligibility for financial and non-financial undertakings began in January 2022, as outlined in the Article 8 Delegated Act of the Taxonomy Regulation. The first reporting period focuses on climate change mitigation and adaptation objectives within the Climate Delegated Act. From January 2023, non-financial companies subject to the Non-Financial Reporting Directive (NFRD) must also report eligibility for the remaining four environmental objectives[20] and alignment to the adaptation and mitigation objectives. By January 2024, non-financial companies will need to report alignment for all environmental objectives.

When examining non-financial companies, the primary goal is to encourage environmentally sustainable behaviour in alignment with the Taxonomy. Reporting KPIs in the EU reveals the percentages of turnover, capex, and opex covered within the taxonomy, with the denominator representing eligibility (activities covered within the taxonomy) and the numerator indicating alignment (demonstrating substantial contribution to one of the environmental objectives, doing no significant harm to others, and meeting minimum safeguards).

[20] The EU Taxonomy includes six environmental objectives. Technical Screening Criteria (TSC) for the first two – climate change mitigation and climate change adaptation – were included in the original Climate Delegated Act. The remaining four environmental objectives – EO 3: Sustainable use and protection of water and marine resources; EO 4: Transition to a circular economy; EO 5: Pollution prevention and control; and EO 6: Protection and restoration of biodiversity and ecosystems – often referred to as "Taxo 4" were initially intended to be in place by 1st January 2023, a year after the TSC for the first two environmental objectives but were significantly delayed. The delegated act was approved in principle on 13 June 2023 and adopted on 27 June 2023.

Credit Institutions (Banks)

Taxonomy disclosures enable banks to assess and manage environmental investments across their balance sheet, allowing them to make more informed lending and investment decisions. Disclosures also help banks demonstrate their commitment to sustainability, attracting environmentally conscious customers and investors. The EU has developed the Green Asset Ratio (GAR) as a KPI for banks, which raises the question of whether the UK should adopt the same approach.

The primary objective for banks is to encourage and incentivise financial actors to direct capital towards green activities, thereby promoting taxonomy alignment. However, calculating the GAR presents challenges related to understanding which assets to include and data gathering. **The GAR, as currently designed, may not actually reflect a bank's overall environmental impact, and does not account for the broader implications of other investments.**

Investors

The primary objective for investors is to direct investments towards green activities, enabling them to construct portfolios with a preference for taxonomy-aligned companies within the same sector. In the EU, the KPI for asset managers is the Green Investment Ratio (GIR), which represents the proportion of investments in Taxonomy-eligible and -aligned activities relative to the value of all covered assets under management (AUM), including money managed on behalf of third parties as well as on their own account. This should then signal the sustainable nature of the investment manager to their own investors and future client base.

However, the GIR may favour an asset manager who executes more on their own account than on third-party accounts, and there is a lack of defining green investments across regions and organisations.

Rationale for GTAG Recommendations

Non-Financial Companies

For non-financial companies, **GTAG recommends focusing on turnover and capital expenditure (capex) as the primary indicators of a company's green performance.**

Turnover acts as a meaningful indicator of a business's current alignment with net zero transition pathways, despite its limitations. It effectively demonstrates the extent of a company's ongoing green activities.

Capex, as a forward-looking indicator, is a valuable metric for measuring the extent of mitigation action taking place in the economy. This is particularly important for governments and other stakeholders who are interested in understanding the effectiveness of such actions. **By examining capex, it is possible to assess whether a company is investing in ways that align with the taxonomy over the medium- to long-term, which is particularly important for companies, such as in the energy sector, which are at the forefront of the transition.**

This information is crucial for investors that want to ensure that their portfolio contains stocks of companies that are poised for strong future sustainability performance.

Regarding operational expenditure (opex), GTAG suggests reviewing whether it should be reported in all cases and whether the EU's definition of opex is appropriate. GTAG believes that opex should not be subject to a mandatory regime. Instead, **GTAG recommend a mandatory approach for turnover and capex, and a voluntary approach for opex.**

There are some challenges in defining turnover, capex, and opex within the context of different accounting principles, such as the variations between UK law and International Financial Reporting Standards (IFRS). **GTAG recommend that clear and consistent definitions for turnover, capex, and opex KPIs should be provided.**

GTAG also recommends expanding capex category C as set out in the EU's Disclosures Delegated Act for the Taxonomy Regulation[21] to cover other environmental objectives, allowing more companies to receive taxonomy credit for their positive contributions. Furthermore, GTAG suggest that capex related to adaptation measures should be counted under the taxonomy adaptation objective, regardless of the company's sector or taxonomy eligibility. In order to fully expand capex category C beyond the confines of the existing activities covered by the Taxonomy, a universal approach to DNSH for sectors not covered by the Taxonomy will need to be adopted by His Majesty's Treasury (HMT).

In conclusion, GTAG recommends prioritising turnover and capex as the key indicators of a company's green performance, while opex should remain voluntary after the two-year term elapses. This approach can provide investors with valuable insights into both current and future sustainability performance, guiding decision-making and promoting sustainable business practices. Should opex be considered for reporting, then its application should be structured to incentivise good operating practices such as sourcing renewable energy in day to day operations of the company, operating low emission transport methods or suppliers, etc.

Credit Institutions (Banks)

GTAG recommend that the GAR be reconsidered, as it may not accurately represent a bank's green activities and could favour certain bank structures over others. If it is to be adopted, it should either exclude non-relevant activities/investments, or be limited to the lending book.

It is also recommended that the development of a Technical Screening Criteria (TSC) for financial services be explored, to capture and measure incentive schemes. This would credit banks for mitigation and adaptation efforts by the companies they lend to, thus encouraging behaviour aligned with net-zero objectives, such as transition-plan lending activities, mortgage incentive schemes for energy efficiency, or green advisory services.

A green mortgage, for example, is not just a mortgage offered to a green property but an incentive scheme. The interest rate could be discounted if the borrower improves the energy efficiency of the property in line with the renovation technical screening criteria. Similarly, car financing could offer premium discounts for zero-emission vehicles compared to petrol or diesel vehicles. The TSC for financial services could then measure the proportion of a bank's income generated from these incentive schemes, or another metric like proportion of lending.

The original TEG recommendation focussed on a bank's loan book. However, the GAR, as currently constructed, is not easily comparable and may favour retail banking over investment banking models. This is due to the inclusion of derivatives, for instance, in the denominator but not the numerator. To address this, it is suggested to limit GAR to a bank's lending book, which could be expanded over time to include all banking activities that direct capital towards taxonomy-aligned projects, or to apply TSC to activities that incentivise greener behaviour. This would involve creating a TSC for financial services that capture green incentive schemes, such as the number of green bonds issued by the bank or lending to taxonomy-aligned businesses. Either of these approaches would remove elements of chance and allow for fairer comparison between banks. **GTAG also recommend that a list of included and excluded assets should be created.**

Ultimately, the recommendation is to either exclude non-relevant activities/investments from the GAR or restrict the GAR to the bank's lending book only[22]. In addition, GTAG recommend that Government consider setting up a working group to design financial services TSC. This would measure and incentivise financial firms to invest in green initiatives, thus encouraging banks to contribute to the transition.

[21] The Disclosures Delegated Act specifies the content and presentation of disclosures required in accordance with Article 8 of the Taxonomy Regulation. Capex C is defined by the EU as capital expenditures related to the acquisition of production from Taxonomy-eligible economic activities and individual measures that enable the target activities to become low-carbon or lead to greenhouse gas reductions.

[22] With the lending book being the denominator and any taxonomy-aligned activity being included in the numerator.

Investors: Asset Managers

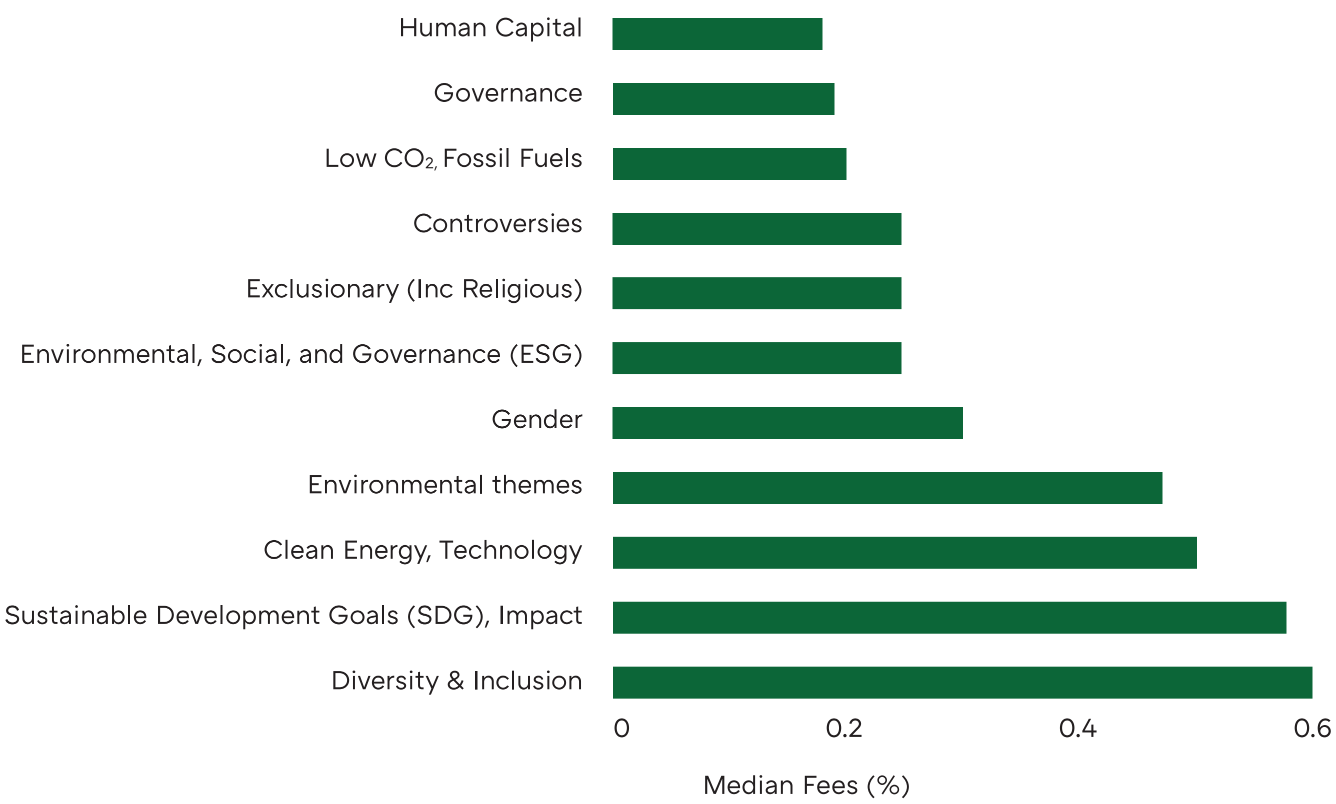
Considering that most asset managers work on behalf of someone else, the GIR might not provide significant value. Instead of focusing on the GIR, GTAG recommends reporting at the fund level to provide a clearer picture of current and future performance in line with net-zero goals. This should be done for all funds, regardless of whether they are labelled as ESG or not, to allow for better comparability and reduce the likelihood of greenwashing.

Recent analysis by MSCI[23] indicates a significant misalignment between European funds and the EU Taxonomy, potentially hindering sustainable investment efforts. The study found that a vast majority (88%) of Article 8 and 63% of Article 9 funds reported no taxonomy-aligned investments. Additionally, only 2% of European-domiciled equity funds and none of the fixed income funds had at least 20% of their revenue aligned with the taxonomy. Out of the 13,419 European funds analysed, including 6,603 Article 8 or 9 funds, only 126 reported EU Taxonomy-aligned revenue. Most of these (114 funds) reported zero aligned revenue. The situation was even worse when it came to reported capex and opex alignment with the EU Taxonomy.

GTAG's recommendation for fund-level disclosures for taxonomy components for all funds, irrespective of labelling, could ensure greater transparency, standardisation, and accountability, making it easier to compare different funds and track overall progress towards taxonomy alignment.

Historically, ESG funds have had more stringent reporting requirements than other funds. This has meant that they have typically demanded higher management fees. Another reason for this is the substantial labour required for extensive data collection and thorough due diligence, due to these stringent requirements, which necessitate additional resources. These increased relative fees are depicted in Figure 2 below. **By requiring taxonomy reporting for all funds, this fee structure should equalise. GTAG suggest that the GIR be dropped in favour of disclosing the taxonomy components for each fund, providing a more useful and relevant metric for investors.**

Figure 2: **Annualised ETF Fees by Strategy**



Source: Bloomberg Intelligence

[23] https://www.msci.com/documents/10199/f89743d6-037f-bb73-1750-d606482224b0

Table 3: **ETFs Created, Median Fees by Year of Inception**[24]

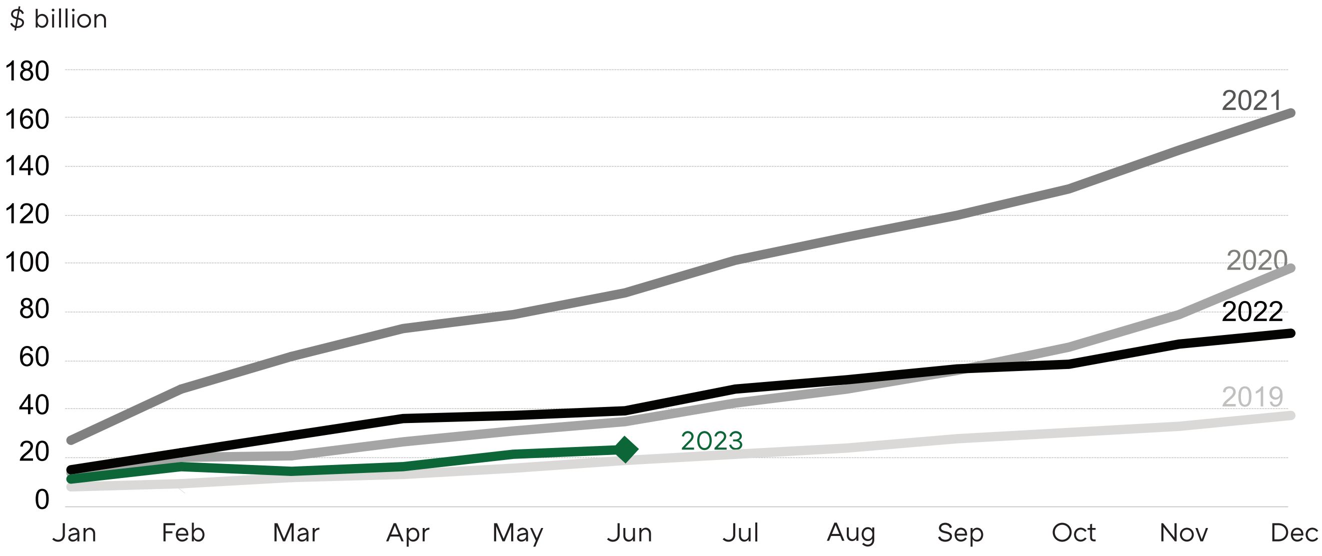
Year	# Funds Created	Median Expense
1Q 2023	58	0.35
1Q 2022	101	0.32
2022	357	0.30
2021	418	0.30
2020	226	0.22
2019	96	0.30
2018	117	0.20
2017	49	0.30

Table 4: **ESG ETFs – Active vs. Passive Strategies**

ETF Type	Funds (%)	Median Fees (%)
Active	16%	0.45
Passive	84%	0.25

Source: Bloomberg Intelligence

Figure 3: **Cumulative ESG ETF Flows, by year**



Source: BloombergNEF

[24] Includes new strategies launched, not additional share classes of existing strategies.

Investors: Insurers

GTAG recommends differentiating between insurers' proprietary investments and their unit-linked or with-profit businesses. Specifically, GTAG recommend that insurers' own-account investments, made to offset the liabilities accrued from their underwriting activities, be reported at the entity level. On the other hand, their unit-linked or with-profit businesses, where the policyholders assume the investment risks and rewards, should be reported at the product level, as the insurance company are operating in an agent role. Such a distinction is hoped to stimulate sustainability integration into general-account investments and to encourage a broader range of green unit-linked and with-profit product options for customers.

The insurance industry in the UK plays a crucial role in the economy, managing investments amounting to £1.9 trillion – the largest in Europe and fourth largest in the world[25]. Insurers already invest in sustainable activities such as renewable energy projects, which are a good match with their long-term liabilities, but as insurance companies increasingly emphasise their sustainability practices, maintaining firm-wide consistency becomes a challenge, especially across their general account, unit-linked, and with-profit investments.

- **Proprietary Investments:** For certain insurance products, such as life insurance and pension products, the time elapsed between an insurer receiving premiums and when they pay out claims can span over many years, even decades. In order to preserve the value of the premiums received, ensure that they can meet their financial obligations to policyholders, offset inflation, and fund the day-to-day operations of the business, insurance companies invest the premiums and seek investment returns to balance the liabilities accrued from their underwriting activities. The insurer shoulders the investment risk and reward.

- **Unit-Linked or With-Profit Investments:** The insurance company, in this instance, acts in an agency role, investing the policyholders' premiums in a variety of assets, with investment returns directly influencing the policy's value, and with the policyholder assuming the investment risk. The UK represents the largest unit-linked market in Europe, accounting for 43% of the region's unit-linked assets[26].

This dual reporting, at both the entity and product level, was deemed to be necessary because proprietary investments form a greater proportion of an insurance firm's business model[27], that is to say a greater percentage of their overall invested assets, when compared against the majority of asset management firms that primarily manage investments on behalf of clients. These traditional asset management firms instead typically earn fees for managing these investments, usually a percentage of the assets under management (AUM). Following the 2008 financial crisis, regulations in many countries, such as the Volcker Rule in the US, have imposed restrictions on the proprietary trading activities of certain financial institutions. Sometimes asset management firms might invest in their own funds alongside their clients, so the line between proprietary and client investments can sometimes be blurred, this however would be captured by an all-fund reporting regime, as recommended by the GTAG.

Considering that the objective is to determine the extent to which an insurer's activities are directed at funding activities identified as environmentally sustainable under the taxonomy, **GTAG has made the determination that differentiating between these different areas of the business will allow for the evaluation of the transitioning process within each segment of an insurance company's operations. It is also the view of GTAG that a TSC for financial services related to insurance premium discounts, adaptation measures, and financing activities for mitigation or adaptation will support this.**

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25 https://www.abi.org.uk/data-and-resources/tools-and-resources/regulation/insurers-as-investors/
26 Approximately 75% of UK unit-linked assets are outsourced to external managers.
27 The split between proprietary investment and unit-linked or with-profit investments can vary significantly between different insurers and over time due to numerous factors. Each insurer has its unique investment strategy based on its risk profile, business model, and the insurance market in which it operates.

Annex

Who reporting obligations are aimed at

The Taxonomy could impose reporting obligations on a number of user types across the UK Taxonomy, including:

- Investment or Asset Managers; including occupational pensions providers and insurance-based asset management firms;
- Credit Institutions;
- Non-Financial Companies;
- Insurance providers, which under the EU regime are required to report separately on their liabilities alignment within the climate change adaptation objective.

GTAG have advised on two reporting obligations that already impact UK companies with European legal entities above a certain size and UK investment managers who offer products into the European market. These obligations include:

- Taxonomy Regulation 'Article 8' or entity-level reporting
- Taxonomy Regulation 'Articles 5 & 6' or product-level reporting

Most companies providing Taxonomy reports are based in the EU, but some international companies not subject to mandatory reporting have produced proxy reports to the EU Taxonomy. Data quality concerns often revolve around the quality of reports made by these international companies, either by themselves or via proxy or estimations without robust guidance on the standards expected by estimates models. A set of standards that outlines a clear equivalence framework should help address these issues.

If the UK Taxonomy is not implemented, or if equivalence with the EU is not achieved, then GTAG estimate 80%[28] of UK listed firms and all UK investors who market products to European clients will still need to conform to the EU Taxonomy, under a new reporting regime called the Corporate Sustainability Reporting Directive (CSRD).

The CSRD aims to harmonise ESG disclosures across the EU market by introducing detailed reporting rules that will require roughly 50,000 companies to report against a mandatory set of sustainability standards – the so-called European Sustainability Reporting Standards (ESRS) – which will encompass environment, social and governance issues. At the high-level, the scope of the legislation includes:

a) All listed companies on an EU regulated market (including listed SMEs, but not micro-enterprises)

b) All large companies exceeding two of the three following criteria:
   1. 250 employees during the financial year
   2. Balance sheet total EUR 20 million
   3. Net turnover EUR 40 million

c) Non-EU companies generating a net turnover of more than EUR 150 million and having a subsidiary in the EU that follow the criteria applicable to EU companies (i.e., being listed on the European market except micro or being within the large company threshold in point b) above) or a branch in the EU generating more than EUR 40 million net turnover

d) Captive insurance and reinsurance undertakings, as well as small and non-complex institutions, provided they also qualify as large companies or SMEs

It is important to note that the CSRD includes an equivalence mechanism for non-EU companies. For example, if the non-EU parent of an EU subsidiary reports under so-called "equivalent" reporting standards to the ESRS (and the EU subsidiary reporting is included within the consolidated report), certain reporting exemptions may apply. At this stage, it is challenging to understand which other standards may be considered equivalent to the ESRS, largely because the ESRS are extremely comprehensive and granular. Moreover, the ESRS integrate the "double materiality" principle, in contrast to the standards being developed by the International Sustainability Standards Board (ISSB – which the UK, Hong Kong, and Singapore plan to adopt).

Whilst the criteria for assessing equivalence have not yet been established, the European Commission could, for instance, consider whether the non-EU company's home jurisdiction has a local taxonomy (including reporting rules against this taxonomy) that maintains the same principles of net-zero alignment when determining equivalence.

[28] GTAG (2023) Promoting the international interoperability of a UK Green Taxonomy. Available at: https://www.greenfinanceinstitute.co.uk/wp-content/uploads/2023/02/GFI-GTAG-INTERNATIONAL-INTEROPERABILITY-REPORT.pdf

Reporting for green bond issuance

Finance is a critical enabler of transformative improvements in existing industries in the UK and globally. Transformation cannot be financed solely by the public sector. Mobilising the $3-6 trillion needed each year to transition to net-zero emissions and climate-resilient economies by 2050 will need private finance to align with these efforts[29]. Therefore, the UK Taxonomy has been designed to explain what 'good' (environmentally sustainable) looks like to corporate actors in heavy emitting UK industries and to stimulate the investment in transforming companies to operate in an environmentally sustainable way.

Critical components of those objectives need to be:

- Corporate disclosure explaining current performance and future investment
- Stimulus to financial markets to invest in the transition

One argument, alongside reporting capital expenditure, could be that debt markets have an important role to play in financing the transition. Where a company is looking to finance its efforts to reduce carbon emissions or adapt to climate change, it will often raise capital to support the infrastructure development needed to transition. In many cases debt instruments like loans or the issuance of bonds, will be used to help finance any deficit needed for the project.

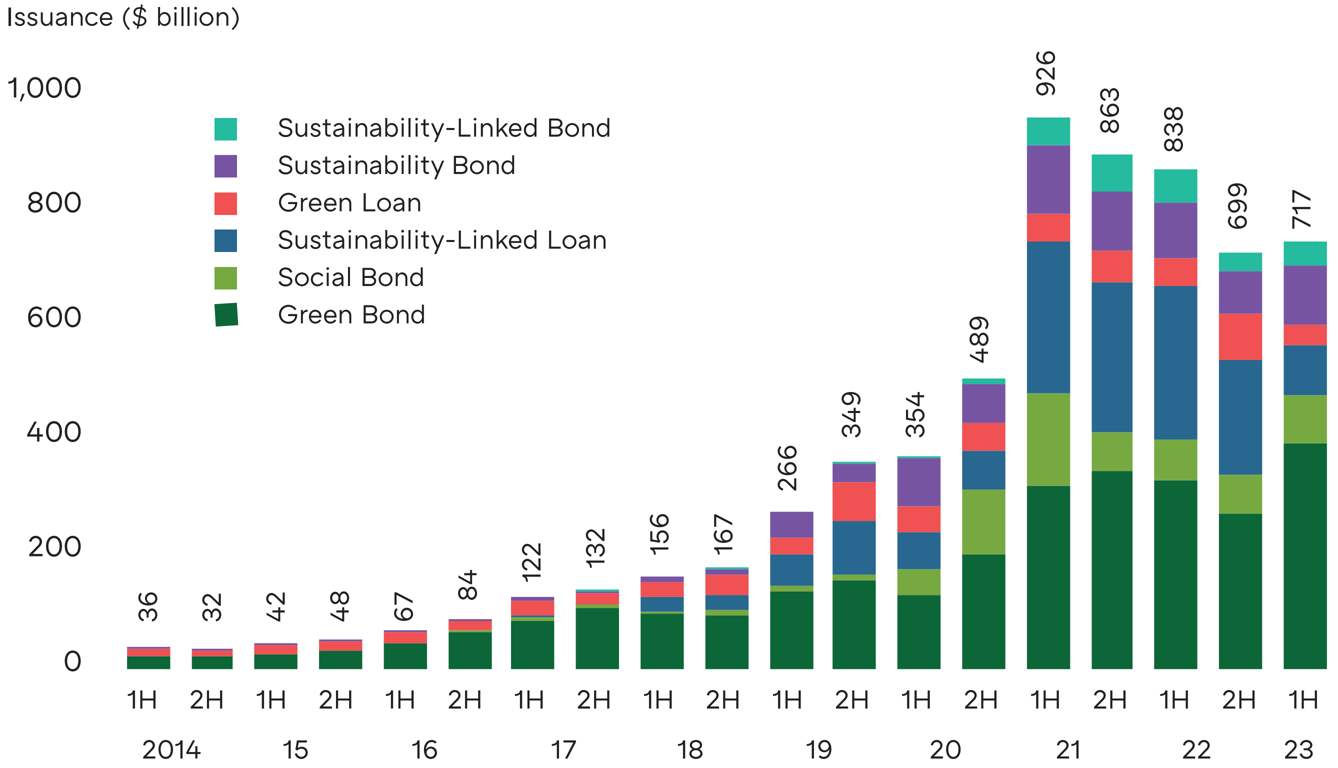
Global sustainable debt reached $717 billion in the first half of 2023, a 3% increase from 2H 2022, driven primarily by a record six-month issuance of green bonds amounting to $380 billion[30]. Sustainability bonds ($99 billion in the first six month), social bonds ($81 billion) and sustainability -linked bonds ($40 billion) all grew their issuance levels in 1H 2023. Despite being a critical tool in financing transitions for businesses and countries, sustainable bonds made up just 2.18% of the total bond market in the first half of 2023.

The green premium (greenium) peaked in 2020 at a median of 2.4 basis points (bps), and has fallen since, becoming a new issue premium of 1.1bps in 2022 – meaning companies now have to offer a higher interest rate on average than when issuing so-called vanilla debt.

Issuers in the clean energy sector secured the largest new bond interest-rate concessions, at an average of 6.7bps between 2020 and 2022. Financials, the second-largest green bond issuers, on average had greeniums of 1.7bps over the same period. On the contrary, gas utilities secured rates averaging 5.9bps above their existing interest-rate curves. Currency, maturity, and country of issue are also big determinants. In France, for instance, green bonds with a maturity over 20 years can fetch new issue concessions of 10bps on average, whereas shorter maturity bonds have been priced above the curve. Bonds denominated in Australian and Japanese currencies saw the biggest greeniums.

[29] https://www.unep.org/news-and-stories/speech/investment-and-trade-meet-paris-climate-goals#:~:text=Mobilizing%20the%20USD%203%2D6,to%20align%20with%20these%20efforts
[30] BloombergNEF 2H 2023 Sustainable Finance Market Outlook

Figure 4: **Sustainable debt issuance by instrument**



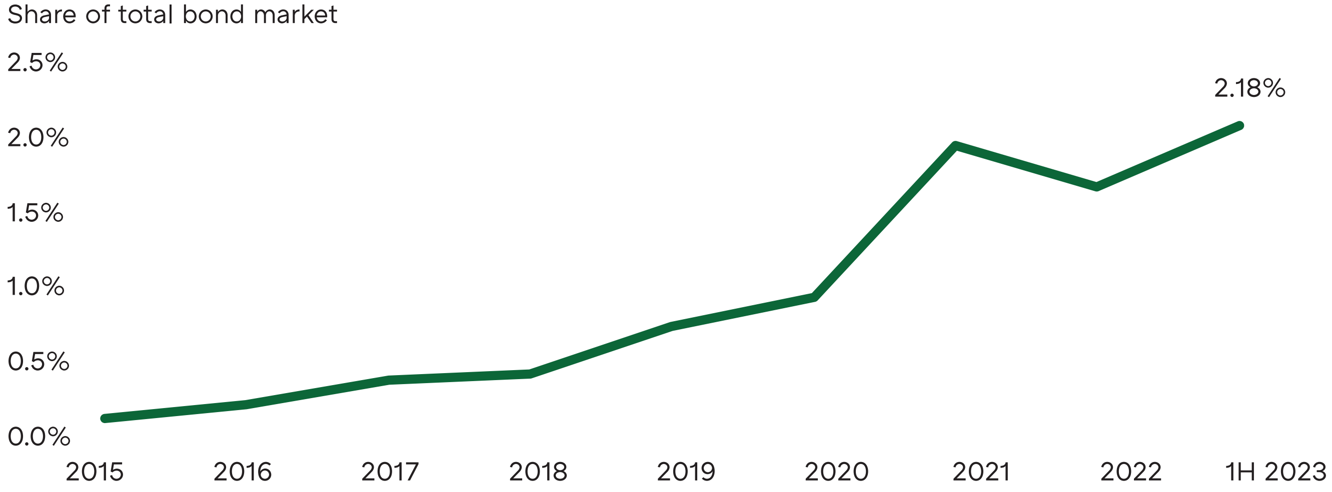
Source: BloombergNEF

Figure 5: **Sustainable debt labels and characteristics**

Debt type	Dept style	Purpose	Market size ($ billion)	1H 2023 Versus 1H 22	2H 22
Green Bond	Activity-based	Environmental projects	2,821 (43%)	19%	45%
Sustainability-Linked Loan	Behavior-based	Institutional ESG targets	1,366 (21%)	-68%	-57%
Green Bond	Activity-based	Environmental projects	770 (12%)	-30%	-56%
Sustainability Bond	Activity-based	Environmental and social projects	735 (11%)	7%	40%
Social Bond	Activity-based	Social projects	633 (10%)	18%	24%
Sustainability-Linked Bond	Behavior-based	Institutional ESG targets	253 (4%)	-26%	25%
Total			**6,577**	**-14%**	**3%**
	Activity-based		**4,959 (75%)**	**13%**	**25%**
	Behavior-based		**1,619 (25%)**	**-60%**	**-45%**

Source: BloombergNEF

Figure 6: **Sustainable bond's share of total bond market**



Source: BloombergNEF

On this basis, one option for UK Taxonomy reporting could be to only require taxonomy-based disclosure on debt instruments; both privately and publicly issued. This would mean that a company or the UK government looking to raise finance for a given 'green' or 'environmentally sustainable' project would need to declare the Taxonomy-alignment of the use of proceeds. In practice, this would mean that the project, at maturity, would need to demonstrate that it substantially contributes to at least one environmental objective whilst doing no harm to any other[31].

The reporting regime could be a requirement for green debt or could be a more general requirement for debt issuance. Thus, forcing all new issues to consider whether or not they are aligned or could be aligned to the UK Taxonomy.

[31] GTAG will shortly be publishing advice on approaches to grandfathering green investment and data gap proxies.

Option One
Voluntary Disclosure Framework

Green debt is currently self-declared as 'green' based on a set of sustainably-linked principles or environmental outcomes; at the moment disclosures can be company self-derived or more traditionally would follow a specific framework for disclosure like the Climate Bonds Initiative (CBI) or the International Capital Markets Association (ICMA). Concern has been raised on the legitimacy of green-labelled debt and the double counting that can result in the secondary market.[32] Option One would see that any debt instrument looking to be classified as green would need to be assured by an independent third party as meeting a certain proportion of its use of proceeds as Taxonomy-aligned. This would follow the same recommendations made by the Technical Expert Group (TEG) of the European Commission.[33] The TEG proposed a European green bond standard (EUGBS) as a voluntary standard to help scale up and raise the environmental ambitions of the green bond market.

Option Two
Mandatory Disclosure Framework

A legislative framework to guarantee the environmentally sustainable credentials of green debt, using the UK Taxonomy. The European Commission explored the possibility of a legislative initiative for a European Green Bond Standard via a public consultation[34] on the renewed sustainable finance strategy in 2020. Based on the outcome of these consultations, Europe has been pursuing a Green Bond Standard. The UK can choose to adopt a similar approach, but this would require reporting in line with the UK Taxonomy and a set of FCA licensed third party verifiers upon whom the responsibility of assuring the green debt would rest.

GTAG have considered that the UK Taxonomy could be initially applied to debt labelling, either voluntarily or mandated, before considering a full corporate reporting regime. Where most of the transition is based on financing investment in infrastructure, transport or real estate, debt instruments play a significant part in supporting the UK government achieve its net zero targets.

GTAG has recently recommended that the UK government should announce plans for a Green Bond Standard, aligning use of proceeds to the UK Green Taxonomy, building on the green gilt framework[35]. These Green Bond Standards should initially be voluntary and factor in GTAG advice on grandfathering.

[32] A $180 Billion Green-Debt Boom Grows Faster Than Its Climate Change Impact - Bloomberg
[33] Technical expert group on sustainable finance (TEG) (europa.eu)
[34] https://finance.ec.europa.eu/publications/consultation-renewed-sustainable-finance-strategy_en
[35] www.greenfinanceinstitute.co.uk/wp-content/uploads/2023/08/GTAG-Final-Report-on-Policy-Links.pdf

Financial and non-financial reporting

March 2020 TEG report deep-dive | Original disclosure recommendations

The European Commission set up a Technical Expert Group on Sustainable Finance (TEG) to assist it in developing their Taxonomy. In March 2020, the TEG released a report on the EU Taxonomy with recommendations on how it should be built and the reporting framework around it.[36] The TEG looked at three sets of Taxonomy users and the intended application of the Taxonomy to the Non-Financial Reporting Directive (NFRD).

The Taxonomy Regulation sets out three groups of Taxonomy users:

1.

Financial market participants' offering financial products in the EU, including occupational pension providers;

2.

Large companies who are already required to provide a 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.

The final recommendations looked at two KPIs:

- the proportion of turnover aligned with the Taxonomy; and
- capex and, if relevant, opex aligned with the Taxonomy

When applying these metrics to financial companies, a derivative-form of reporting was proposed; such that investments in taxonomy-aligned companies was a more meaningful metric than the financial company's own sustainability practices e.g., investments in offices or low carbon transport. The TEG also made a recommendation on differences between environmental objectives such that mitigation would count for transitional as well as enabling activities, but adaptation was either investment in adapting (capex-based) or enabling (turnover-based).

Table 5: **TEG Recommendations for Financial Metrics and Climate Change Considerations**

Financial metric	Climate change mitigation	Climate change adaptation
Turnover	Can be 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 activities 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.

[36] Technical expert group on sustainable finance (TEG) (europa.eu) report TEG final report on the EU taxonomy (europa.eu)

The TEG also made recommendations on due diligence-based approaches to validating a company's compliance with certain testing criteria, for example minimum social safeguards as opposed to a data-led pass/fail model. With regard to verification, the TEG's recommendations were that external assurance on Taxonomy-related disclosures should be sought.

Specific disclosures for financial companies were broken into equity and debt-based investments. For asset managers, the TEG's recommendations were fund-level; to show to the asset owner the proportion of their investment that was Taxonomy-aligned using both a turnover and capex-based indicator. The TEG recommended disclosures in both pre-contractual and periodic reporting. For credit institutions, the recommendations were based on disclosures related to the lending activities and not over the full balance sheet of the bank.

Table 6: **TEG Recommendations for Financial Reporting KPIs**

Equities	Fixed Income (Corporate)
1. % of the fund that complies with the Taxonomy; breakdown by environmental objectives; and breakdown by activities (all weighted). Investors are required to disclose the % of the fund invested in 'transition' and 'enabling' activities. 2. % of the fund that is potentially Taxonomy-align breakdown by environmental objectives and activities. Commentary following recommendations. 3. (Until the Taxonomy is finished) % of the fund that responds to environmental objectives 3–6, and a breakdown by objective, including an explanation on the methodology and criteria used following recommendations.	Same as equities. In addition, when appropriate, breakdown by: 1. % invested in bonds compliant with EU Green Bond Standard (100% Taxonomy-aligned); 2. % of the fund invested in green bonds partially aligned (and % that is Taxonomy-aligned); 3. % of the fund invested in corporate bonds (and the % that is Taxonomy-aligned).
What to disclose: Turnover. Some investors, however, might decide to build a forward-looking portfolio and disclose the same information based on capex.	**What to disclose:** Capex, and opex if relevant. For corporate bonds, turnover could be used in selected cases, as appropriate, where capex does not properly represent the investments made by the issuer. If both metrics are used (e.g. one for green bonds, one for corporate bonds), it needs to be specified and reported separately.

The TEG also made recommendations on four common design principles for international Taxonomy harmonisation focusing on:

1) environmental goals
2) a list of economic activities
3) performance metrics
4) performance thresholds for each economic activity

The TEG stated that "A common design approach between international taxonomies would enable mutual recognition of Taxonomy frameworks and support market understanding of the environmental performance of economic activities and investments across markets."[37]

So, in conclusion, a TEG-like approach would see:

1) Non-Financial corporate reporting of turnover and capex KPIs within the existing non-financial disclosure of the firm
2) Financial reporting to focus on what they invest, not how they themselves align with Real Estate, Energy or Transport testing criteria
3) Asset or Investment Managers should report Taxonomy-metrics at fund-level to their asset owner in pre-contractual and periodic reporting
4) Credit institutions should report Taxonomy-metrics for lending and debt capital market activities

[37] P.53 TEG final report on the EU taxonomy (europa.eu)

Current EU disclosure regime

The EU Taxonomy reporting regime deviated from the recommendations made by the TEG in several ways. While the TEG had proposed a more streamlined and user-friendly framework, the final EU Taxonomy requirements became more complex, resulting in challenges for reporting entities. The TEG's initial recommendations were aimed at providing clear and easily understandable reporting guidelines, but the subsequent regulatory adjustments led to a more intricate and less accessible framework. This shift away from the TEG's suggestions has contributed to confusion and misreporting among reporting firms, as they struggle to fully comprehend and adhere to the extensive and intricate EU Taxonomy reporting requirements.

Non-Financial Companies

The EU requires non-financial companies to disclose % revenue, % capex, and % opex (on a comply or explain basis) metrics. Turnover refers to net revenue from product sales and service provisions. Capex includes investments or additions to tangible or intangible assets during the financial year, aligned with IFRS. Opex covers costs related to research and development, short-term leases, maintenance, renovation, and other direct expenditures for day-to-day asset servicing. The EU definition does not currently cover expenditure in the purchase of renewable energy, for example.

However, there are challenges with each of these metrics. For instance, turnover does not always provide a complete picture, as seen in the below example from Europe's largest private forest owner, where end revenue does not accurately reflect the company's sustainable practices. Despite its issues, a turnover based KPI is still considered a useful indicator of current performance.

Table 7: **Svenka Cellulosa Aktiebolaget SCA 2021 Taxonomy Disclosure**[38]

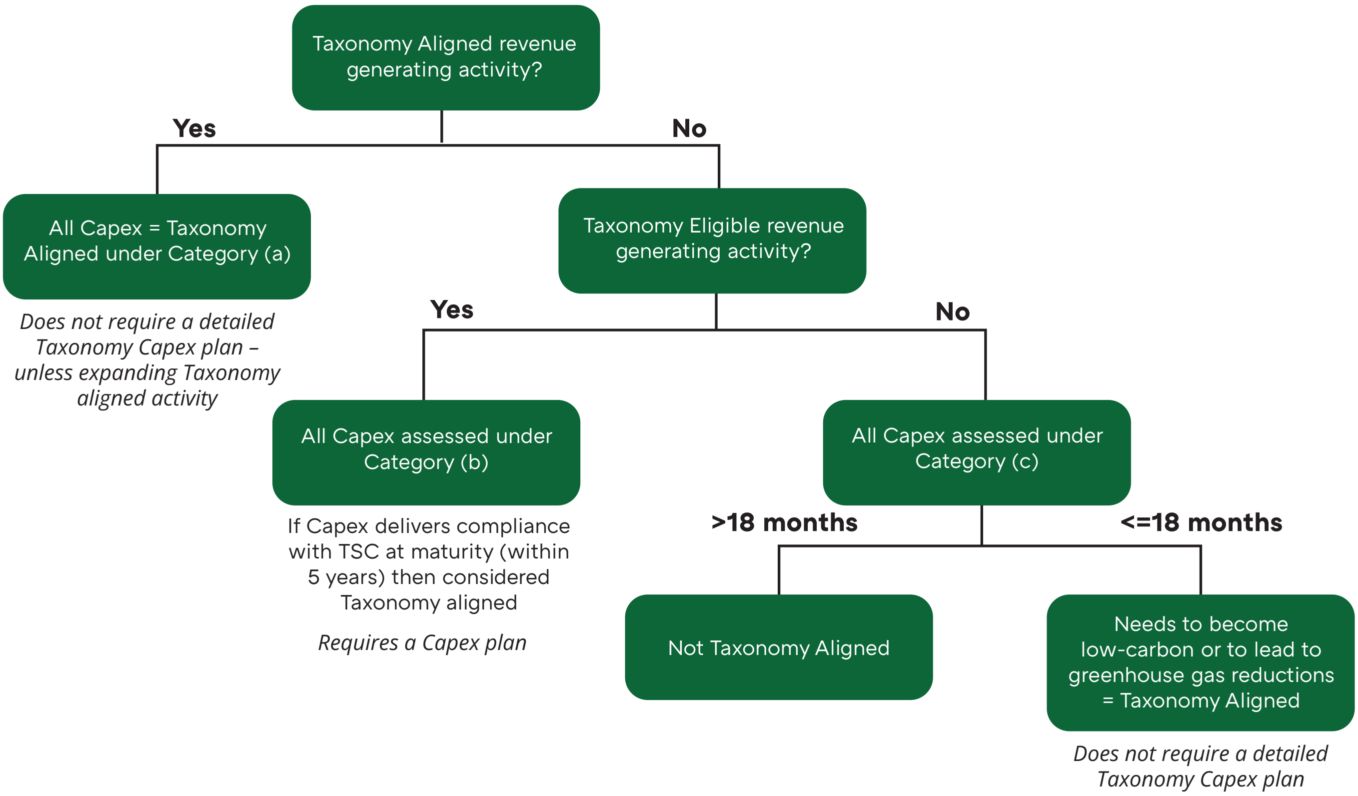
		Based on external sales **Mandatory disclosure**		**Based on external and internal sales** **Voluntary disclosure**	
	Total, SEKm	**Share eligible, %**	**Share non-eligible, %**	**Share eligible, %**	**Share non-eligible, %**
Net sales	18,822	7%	93%	17%	83%
Capital expenditure	5,180	13%	87%	13%	87%
Operating expenditure [1]	1,281	24%	76%	24%	76%
Capital employed [2]	90,807			77%	23%

[1] According to the definition in the EU Taxonomy
[2] Voluntary disclosure

With capex, the main issue lies in the disconnect between capex reporting and debt, as the former needs to be reassessed annually while the latter remains green for its entire duration. This can lead to asymmetry in the reporting framework, especially for transitional activities. Capex is divided into three categories (A, B, and C) as defined by the EU. Category A relates to taxonomy-eligible economic activities, category B covers investments for expanding or enabling taxonomy-eligible activities, and category C includes expenditures related to the acquisition of production from taxonomy-eligible activities. An issue with capex C is that it currently limits itself to low carbon, which may exclude investments in adaptation criteria and other environmental objectives that should be considered in the taxonomy.

[38] https://www.sca.com/siteassets/investors/reports-and-presentations/annual-reports/2021/annual-report-2021.pdf

Figure 7: **Platform for Sustainable Finance (PSF) Explanation of Capex Categorisations**



Opex, initially suggested for SMEs in the absence of capex, is comply or explain. However, it has usability concerns and connectivity issues with IFRS. The EU Commission's Q&A documents from December[39] referred back to IFRS standards, suggesting a shift towards traditional accounting standards for taxonomy reporting. Opex is also divided into three categories (A, B, and C) like capex.

Currently, capex is more meaningful as it indicates investments towards a greener economy. In the future, the turnover number will become increasingly important as it will show differentiation in reporting, which is not currently present. The challenges with these KPIs have required supplementary guidance from the EU Commission.

Credit Institutions (Banks)

Starting in January 2024, EU banks must disclose their GAR, including alignment metrics for the financial year 2023. This requires banks to present quantifiable evidence of the extent to which their financed activities align with the EU Taxonomy's definitions of green. The GAR is a ratio that demonstrates the proportion of a credit institution's assets invested in EU Taxonomy-aligned economic activities compared to their total covered assets. However, calculating the GAR presents challenges related to understanding which assets to include and gathering data on the alignment of assets with the EU Taxonomy.

One issue with GAR is that assets may differ across institutions, causing inconsistencies in calculations and interpretations. Moreover, the GAR may not actually reflect a bank's overall environmental impact, as it focuses on green assets and does not account for the broader implications of other investments.

Banks argue that GAR does not fairly represent the environmental impact of their activities. For example, retail banks with a high volume of mortgages typically have a better GAR than investment banks, as trading and derivatives do not qualify under the taxonomy. This suggests that the GAR reflects the type of business a bank engages in rather than its actual environmental performance.

[39] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021SC0183

Furthermore, the GAR calculation excludes certain assets, such as those held for trading, exposures to governments and central banks, and financing to small and medium-sized enterprises (SMEs) or non-EU corporate counterparties. As a result, the coverage and value of the GAR will vary depending on a bank's business model and geographical footprint. Comparing the GAR across different banks may not be appropriate without considering the comparability of their balance sheets.

Banks are also concerned that the GAR does not consider the context and nature of each bank's balance sheet, potentially favouring one structure of a bank over another. For instance, if a mortgage portfolio contains energy-efficient properties, it does not necessarily mean the bank actively supported their energy efficiency improvements. Therefore, banks should be incentivising energy efficiency through mortgage products with financial incentives, rather than merely reporting the number of green properties in their portfolio.

Some issues could be addressed through the Technical Screening Criteria, such as incorporating value chain assessments for companies. By including sustainability factors in the TSC, like the sourcing of materials and workforce treatment, a more comprehensive picture of a company's sustainability efforts can be achieved. The EU PSF is tasked with assessing the value chain, potentially providing supplementary guidance to the current TSC.

Investors

In the EU, the Green Investment Ratio (GIR) serves as the KPI for asset managers. The GIR measures the proportion of investments in Taxonomy-eligible and -aligned activities relative to the value of all covered assets under management.

However, the GIR has some limitations. For example, it may favour an asset manager who executes more on their own account than on a third-party account. This issue arises because the GIR does not fully account for the fact that a significant portion of financial activity is conducted in an agent capacity. As a result, an asset manager that appears more favourable compared to another may be due to structural differences rather than actual performance in promoting green activities.

Additionally, there is inconsistency in defining green investments across regions and organisations. This lack of standardisation present challenges for evaluating and comparing the true sustainability performance of various investment managers.

October 2022 PSF report

In October 2022, the EU Platform on Sustainable Finance (EU PSF) published two final reports, providing insights on Data and Usability of the EU Taxonomy[40] and Minimum Safeguards[41].

The report identified all taxonomy users and uses, outlines the challenges faced by users applying the taxonomy, and recommends solutions. Usability issues covered in the report include:

- **Misalignment,** between the sustainable finance reporting requirements across different regulations, notably with the same terms having different meanings depending on the regulation (e.g., do no significant harm).
- **Sequencing issues across the reporting framework,** ensuring that the data is available to financial institutions in order to satisfy their own reporting obligations.
- **Regulatory overload,** ensuring that the regulatory requirements are evenly distributed and proportional.
- **Interpretation issues,** ensuring reporting requirements are clearly understood by all user groups (what needs to be reported, how and by when).
- **Regulatory and data gaps,** filling any regulatory gaps or addressing any regulatory hurdle that might hinder the user of the taxonomy and fostering the availability and accessibility of data.

The Platform make recommendations covering the Taxonomy Regulation, but also extending beyond the Taxonomy, with the objective of improving policy consistency and alignment across the EU's sustainability and financial reporting regulatory framework.

- The recommendations made by the Platform in relation to eliminating requirements to calculate Taxonomy-aligned of portfolios using opex is consistent with GTAG's recommendations on the metric.
- The Platform also suggest a consistent approach to calculating the numerator and denominator for Taxonomy reporting requirements to improve consistency, alongside better verification, and assurance of taxonomy reporting.
- One recommendation refers to the considering of equivalence tables between regional certification and labelling schemes, as well as translation of EU regulation criteria into more internationally assessable quantitative and/or process-based criteria. This extends to developing a common understanding of key environmental metrics and their calculation methods.

The main usability issues observed were companies not reporting across all three indicators – turnover, capex, and opex – and a lack of consistency between reporting in absolute and percentage terms. Examples include:

- **Structural issues:** the use of incorrect templates, number formatting and naming conventions (e.g., green share of turnover as opposed to taxonomy-aligned turnover).
- **Interpretive issues:** incorrectly apply reporting metrics (e.g., on alignment of opex); and
- **Technical issues:** interpretive issues on what constitutes an eligible activity.

The main recommendation targets the exclusion of the requirements for investors to calculate Taxonomy-alignment of their portfolios using opex, as the metric is difficult to find and adds little value for end-investors.

Concerns and recommendations largely mirror conclusions GTAG has made about a UK Taxonomy, for example, if a UK company reports under the UK Taxonomy, it shouldn't have dual reporting burden under the EU. Instead, an equivalence system should be put in place.

[40] Data and Usability of the EU Taxonomy
[41] Minimum Safeguards

Other international approaches

Bangladesh, Malaysia, South Africa, and Singapore are considering implementing mandatory taxonomy reporting, while the EU is the only jurisdiction with current mandatory reporting requirements for financial and non-financial companies[42]. The ASEAN Taxonomy, which is principles-based, allows local jurisdictions to determine their own reporting obligations. In the Asia Pacific, voluntary reporting in Singapore, Hong Kong, and Japan is well-received, suggesting a different approach may be effective. As a result, the UK and EU would likely have the strongest frameworks for mandatory reporting obligations.

For interoperability, GTAG recommends that the UK Taxonomy should accept estimates from data vendors, as the taxonomy is designed to be internationally applicable. A significant portion of UK financial investments are global[43], making it crucial for the UK Taxonomy to accept such estimates. The UK should also allow international estimates to its taxonomy and domestic disclosures against other countries' taxonomies. For example, if an EU company uses the EU Taxonomy, a UK investor should be able to use that information. If no disclosure is available, financial organisations could estimate, provided a set of standards is created.

If the UK diverges from the EU and chooses to omit certain KPIs, such as Green Asset Ratio, Green Investment Ratio, and opex, from its reporting requirements, it is essential to ensure proportionality to avoid creating an undue burden on reporting firms. However, GTAG believes that divergence could reduce misreporting through the introduction of more straightforward KPIs. There is still a risk that a European investor might ask a UK bank to disclose under the EU regime. Nonetheless, GTAG maintains that some of the current KPIs do not provide decision-useful data, and therefore, alternatives are preferred.

[42] Other taxonomies have mandatory reporting for issuance of green finance instruments such as bonds, loans, and structured products e.g., commercial banks in Georgia have to comply with, and report against, the Taxonomy criteria when classifying loans as green, social and sustainable.

[43] Approximately 20% of UK asset manager holdings are held in the UK economy, with 80% of holdings abroad, and £4.2trn (44%) of UK-managed assets are for overseas investors (with 58% of these overseas clients being European). https://www.theia.org/sites/default/files/2021-11/IA%20-%20Investment%20Management%20Survey%202020-2021.pdf

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Chair: Ingrid Holmes, Green Finance Institute

Users of the taxonomy – Financial Services

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- HM Treasury
- Department for Energy Security and Net Zero
- Department for Business and Trade
- Financial Conduct Authority
- Bank of England
- Other relevant HMG departments and regulators

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Glossary

ASEAN	Association of Southeast Asia Nations
AUM	Assets Under Management
BPS	Basis Points
Capex	Capital Expenditure
CBI	Climate Bonds Initiative
CSRD	Corporate Sustainability Reporting
DNSH	Do No Significant Harm
EC	European Commission
ESAs	European Supervisory Authorities
ESG	Environmental, Social, and Governance
ESRS	European Sustainability Reporting Standards
ETF	Exchanged-Traded Fund
EU	European Union
EU PSF	EU Platform on Sustainable Finance
EUGBS	EU Green bond Standard
EUR	Euro
FCA	Financial Conduct Authority
GAR	Green Asset Ratio
GIR	Green Investment Ratio
GTAG	Green Technical Advisory Group
HMG	His Majesty's Government
HMT	His Majesty's Treasury
ICMA	International Capital Market Association
IFRS	International Financial Reporting Standards
ISSB	International Sustainability Standards Board
KPI	Key Performance Indicator
NFRD	Non-Financial Reporting Directive
Opex	Operational Expenditure
PAI	Principal Adverse Impact
PSF	Platform on Sustainable Finance
Q&A	Question and Answer
RTS	Regulatory Technical Standards
SDG	Sustainable Development Goals
SDR	Sustainability Disclosure Requirements
SFDR	Sustainable Finance Disclosure Regulation
SLB	Sustainability-Linked Bond
SME	Small and Medium-Sized Enterprises
TEG	EU Technical Expert Group
TSC	Technical Screening Criteria
UK	United Kingdom