Taxonomy Regulation

Impact on Swiss financial institutions

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Overview of the EU Taxonomy Regulation

Through regulation 2020/852, also referred to as the Taxonomy Regulation (TR), the European Union (EU) aims to boost sustainable investment and counter greenwashing. The TR establishes an EU-wide classification system defining which activities are "environmentally sustainable" and how related information must be disclosed.

Classification and disclosure under the Taxonomy Regulation

The TR defines six environmentally sustainable objectives:
- climate change mitigation
- climate change adaptation
- sustainable use and protection of water and marine resources
- transition to a circular economy
- pollution prevention and control
- protection and restoration of biodiversity and ecosystems.

For an activity to be considered environmentally sustainable, it must simultaneously:

(1) provide a substantial contribution to one of the six objectives by complying with technical screening criteria (i.e. the minimum performance requirements for each economic activity covered by the Taxonomy)
(2) not significantly harm any of the other objectives (i.e. not support one environmentally sustainable objective at the expense of progress on another environmental objective), and
(3) respect internationally recognized minimum safeguards (e.g. OECD Guidelines for Multinational Enterprises, UN Guiding Principles on Business and Human Rights).

Ultimately, the objective of the Taxonomy is to provide a framework for corporates to disclose to investors the level of their engagement in environmentally sustainable activities. In addition, based on these disclosures, financial institutions can determine their level of exposure to sustainable activities in their investment or financing activities, for example.

Scope of disclosures and relevance for Swiss financial institutions

The TR foresees certain disclosures both at an entity/issuer level as well as at a financial product level.
- Entity level disclosures: all large public interest financial institutions that are within the scope of the EU's current **Non-Financial Reporting Directive (NFRD)** and/or future **Corporate Sustainability Reporting Directive (CSRD)** will have to disclose at entity level under the Taxonomy Regulation. Figure 1 summarizes the respective thresholds.
- Product level disclosures: the precontractual documents and periodic reports of each financial product classified under the **Sustainable Finance Disclosure Regulation (SFDR)** and marketed in the EU must provide Taxonomy disclosures at product level.

NFRD scope (2014/95/EU)

Large public interest entities with 500+ employees:
- Listed companies
- Banks
- Insurance companies
- Other companies designated by national authorities as public-interest entities

CSRD scope (as of FY2023)

Large entities meeting at least two of the three following criteria:
- 250+ employees and/or
- €40 million turnover and/or
- €20 million balance sheet total

All companies listed on EU regulated markets.
Exceptions:
- Micro-enterprises with <10 employees and/or
- Turnover and/or balance sheet total well below €2 million

Figure 1: Thresholds for companies in scope of NFRD or CSRD, respectively

Swiss financial institutions should be aware that they are likely to be directly or indirectly affected by the TR.

As far as the TR's entity level requirements are concerned, Swiss financial institutions need to assess whether their EU subsidiaries individually meet the criteria of a large public interest entity or whether they act as a parent of a large public interest group. If the result of this assessment is positive, the company is directly covered by the TR and is obliged to provide Taxonomy disclosures.

Where the result of the assessment is negative, Swiss financial institutions with investors based in the EU may be indirectly affected by the TR. EU financial institutions are likely to approach Swiss institutions directly to collect Taxonomy related information and could, in the medium term, be incentivized to turn away from investee companies that do not provide the required information.

At the product level, where Swiss fund managers or managers of segregated portfolios have EU investors that fall directly under the TR scope (e.g. pension funds, insurance companies), the latter will need to collect such information from the former to report on Taxonomy eligibility or alignment, respectively.

Moreover, Swiss fund managers performing portfolio management on behalf of an EU Management Company (ManCo) or Alternative Investment Fund Manager (AIFM) will indirectly be impacted by the TR, as the ManCo or AIFM under the TR scope may need to collect relevant information from the delegated manager.

Gradual phase-in of Taxonomy disclosures

The go live date of the TR was 1 January 2022. However, the EU foresees a transition period for Taxonomy application where disclosure requirements are simplified for the first reference year (fiscal year ending 2022) compared to the following reporting years. Most importantly, for FYE2022 and FYE2023 financial institutions only need to report on the Taxonomy eligibility of their exposures. This means a specific activity is covered by the Taxonomy and thus has the potential to be Taxonomy-aligned. Nevertheless, the technical screening criteria, "do no significant harm" principle and minimum safeguards must be respected for Taxonomy alignment. Figure 2 shows an overview of key entity and product level application deadlines for financial undertakings.

Entity level disclosures for financial undertakings

The EU requires non-financial undertakings to disclose three Key Performance Indicators (KPIs) annually: the proportion of Taxonomy eligibility – or alignment – of turnover, capital expenditure (CapEx) and operating expenditure (OpEx).

As these three KPIs are not appropriate for large financial public interest entities to demonstrate Taxonomy alignment, specific KPIs were defined for credit institutions, asset managers, investment firms and (re)insurers. The disclosure obligations force financial undertakings to adopt a portfolio and asset "look-through" approach based on actual information disclosed by investee undertakings, as opposed to estimates. They must be accompanied by certain qualitative disclosures, such as contextual information on the KPIs. The annexes of the Disclosures Delegated Act provide templates, the use of which is recommended.

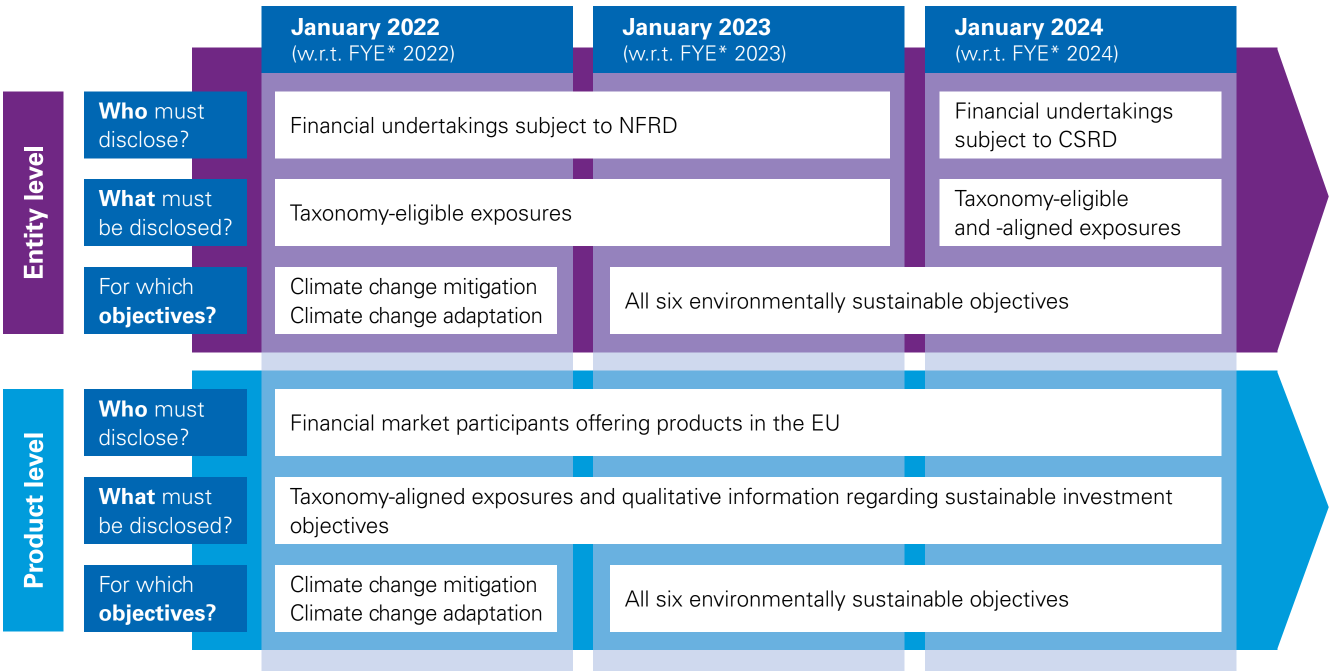

Figure 2: Overview of Taxonomy requirements phase-in for financial institutions
* w.r.t. FYE = with regard to Fiscal Year Ending. Companies disclosing their financial statements in 2022 are commonly referred to as FYE datasets, notwithstanding whether reported information covers the prior or current year. Hence, the statement's submission date is decisive.

i. Credit institutions

Credit institutions must disclose their **green asset ratio (GAR)** to report on the proportion at which the financing activities in their banking book are associated with environmentally sustainable activities. Breakdowns must be made between:

(1) the GAR regarding exposures to non-financial undertakings (i.e. GAR for the stock of loans, debt securities and equity holdings, as well as the flow for new lending to non-financial undertakings)
(2) the GAR for lending activities to and equity holdings of financial undertakings
(3) the GAR for retail exposures (e.g. residential real estate loans, credit consumption loans)
(4) the GAR for loans and advances financing public housing and other specialized lending to public authorities,
(5) other on-balance sheet exposures (i.e. repossessed real estate collaterals)
(6) total GAR (i.e. the aggregated value of Taxonomy-eligible, respectively -aligned KPIs, such as the total GAR for financing activities directed at financial undertakings for all environmental objectives).

Off-balance sheet exposures must be represented by a green ratio for financial guarantees to financial and non-financial undertakings (FinGuar KPI). Moreover, a green ratio for assets under management (AuM KPI) is required. For services other than lending, a fees and commissions Taxonomy alignment KPI (which could be referred to as a "Green Fee Ratio") must be computed. Lastly, credit institutions must provide a GAR for the trading portfolio, accompanied by qualitative information such as explanations on the trading portfolio's investment policy and its overall composition. Figure 3 summarizes how the entity level Taxonomy disclosures of non-financial undertakings feed those of a financial undertaking – in this instance a bank – and how they are both in turn integrated into financial product disclosures.

ii. Asset Managers

Large public interest asset managers must disclose the weighted average of the value of their investments in Taxonomy-aligned economic activities of investee companies, in terms of their assets under management. Moreover, a breakdown between environmental objective, enabling versus transitional activity, type of investment, Taxonomy eligibility, etc. must be provided.

iii. Insurers and reinsurers

Invesments, insurance and reinsurance undertakings falling under the entity level Taxonomy scope must report the weighted average of Taxonomy-aligned investments that fund or are associated with each environmental objective, both as a percentage of total investments and in monetary terms. Additionally, a breakdown between investments through life insurance contracts versus non-life insurance-related investments must be made.

Regarding their underwriting activities, insurers and reinsurers must disclose the Taxonomy KPIs in terms of non-

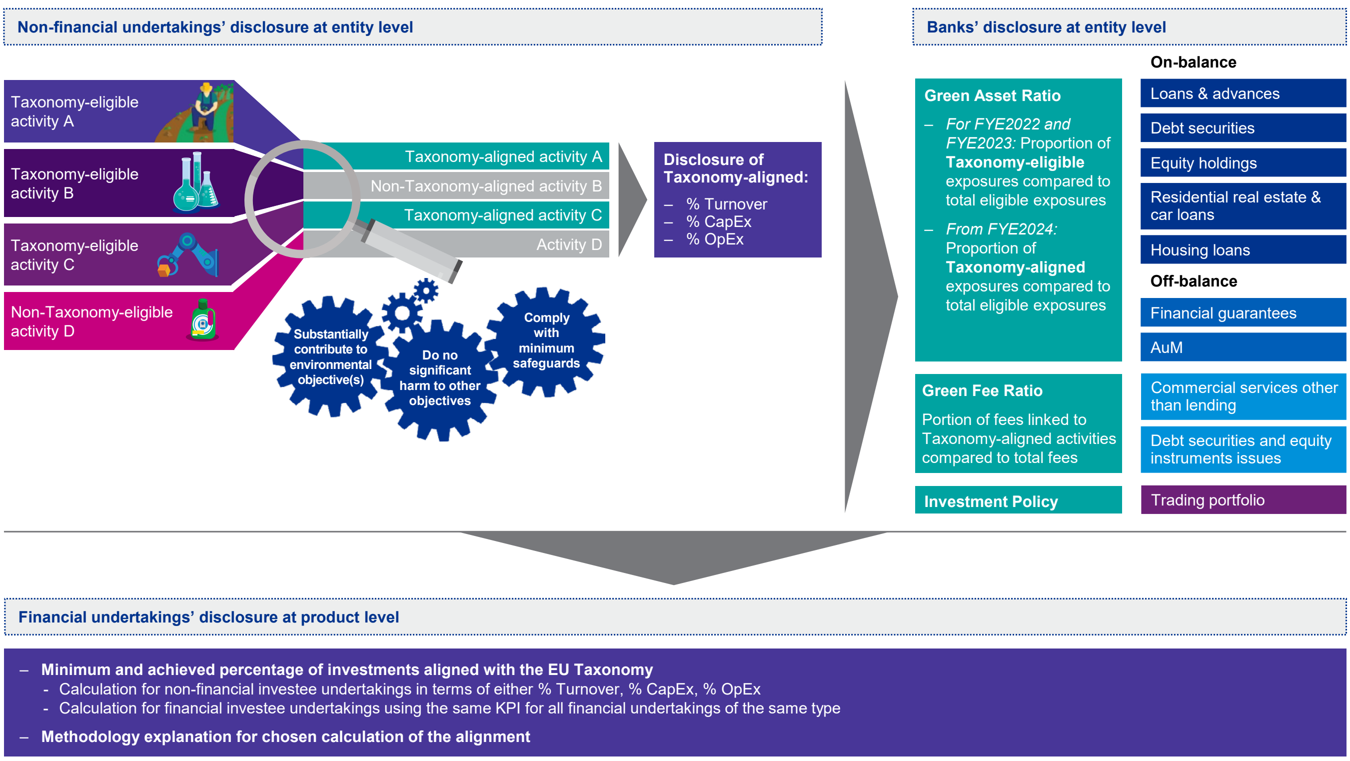

Figure 3: Logic of the Taxonomy Regulation and disclosure requirements

life insurance gross premiums written, reinsurance gross premiums written, non-life insurance revenue and reinsurance revenue. Again, KPIs should distinguish between each environmental objective in percentage and monetary units.

Product level disclosures for financial undertakings

In their role of financial market participants as defined by the SFDR, financial undertakings must also, if they offer financial products in the EU, provide Taxonomy disclosures in financial products' pre-contractual documents and periodic reports. These product-related documents must:

(1) Explain how and to what extent investments qualify as environmentally sustainable
(2) Name the environmental objectives targeted by relevant investments
(3) Compute the proportion of the portfolio's Taxonomy alignment, also specifying the proportion of enabling versus transitional activities.

Conclusion

The implementation of the TR is a major transformation project with the need to involve specialists from the business, compliance, data management, financial reporting and product management, just to name a few. Swiss financial undertakings directly in the scope of the TR depend on information being gathered from third parties (clients or investees) for their entity and product level disclosures. Although the requirements are being phased in gradually, undertakings in scope should not underestimate the resources required to become familiar with the technical screening criteria, engage with various relevant stakeholders inside and outside the company to collect the necessary information (e.g. external data vendors) and prepare related disclosures.

Even for Swiss financial industry players that are only indirectly in scope of the TR, there exists a strong case for taking a proactive approach towards implementing TR requirements in order to strengthen their competitive advantage and to benefit from EU and Swiss investors' increasing demand for sustainable investment and transparency.

How can KPMG help?

Our regulatory and sustainability experts can assist you in navigating the Taxonomy disclosures and prepare your business for compliance with these requirements. Our offering includes:

Determining the Taxonomy disclosure requirements for your business

We engage with stakeholders, review internal documents relating to ESG and identify your Taxonomy-related activities in order to provide you with a Taxonomy disclosure-related universe for your business.

Performing a gap analysis

We assess your Taxonomy performance against the screening criteria, no significant harm principles and minimum safeguards and provide an action plan to close any gaps.

KPI alignment

We support you in calculating alignment of Green Asset Ratio, fees and commissions alignment or qualitative disclosures on the trading portfolio in line with TR requirements.

Disclosure assistance

We support you in drafting and/or reviewing drafted disclosures.

Roadmap to future compliance

We provide a tailored action plan for compliance with future non-financial disclosure requirements.

We can tailor our offering to your needs, leveraging our wider teams where necessary. Please contact us to begin your action plan on Taxonomy disclosures by talking to our team.

Your contacts

If you have additional questions do not hesitate to reach out to our specialists:

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