Integrating ESG and Taxonomy: Strategies for Sustainable Banking

The sustainable finance market reached $35.3 trillion in 2020, which accounts for more than a third of all managed assets. This transformation toward sustainable banking demands clear frameworks and classification systems. Banks now face a key challenge: they need to combine ESG criteria with taxonomy frameworks smoothly to create environmentally responsible banking practices.

The EU taxonomy rules establish a science-based framework for identifying sustainable economic activities. This article examines how banks can align their operations with the objectives of the EU taxonomy while simultaneously developing resilient ESG frameworks. The discussion will encompass various aspects of ESG-taxonomy integration, including the management of data, methods for assessing risk, the development of sustainable products, and the governance structures necessary to ensure the successful implementation of these initiatives.

Understanding ESG-Taxonomy Integration Framework

The ESG-taxonomy integration starts with understanding the basic framework that reshapes environmentally responsible banking. Since 2020, the EU Taxonomy has served as a fundamental classification system that assists companies and investors in identifying environmentally sustainable economic activities [1].

Key Components of ESG Integration

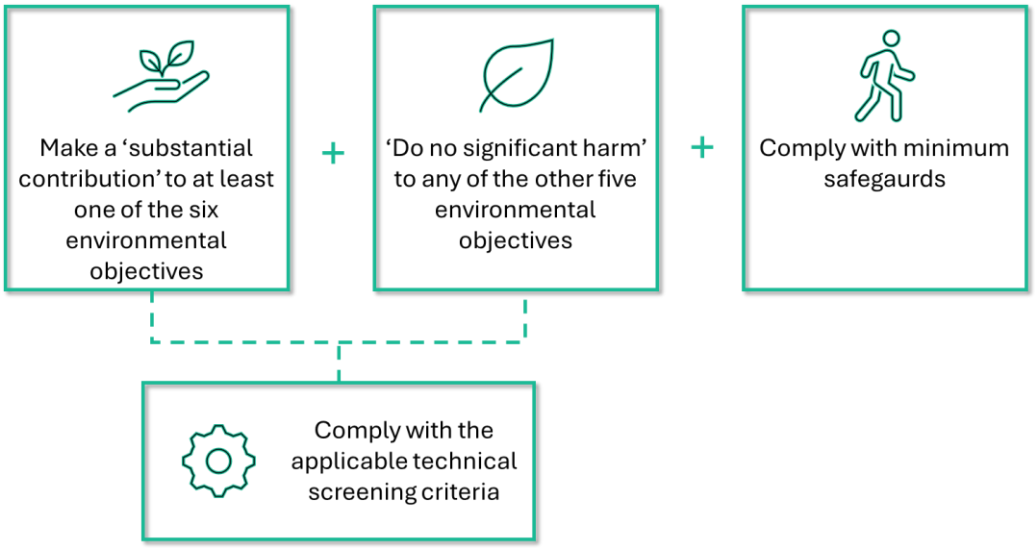
The framework presented outlines how ESG integration facilitates the consideration of both risks and opportunities in banking operations. The key components include:

- **Environmental Assessment**: Focuses on climate change mitigation and adaptation
- **Social Responsibility**: Evaluates labor rights, health standards, and community effects
- **Governance Structure**: Implements sustainability management and board oversight
- **Data Management**: Establishes strong collection and verification systems

Taxonomy Alignment Requirements

The activities must meet four main conditions to line up with the taxonomy [2]:

1. Making substantial contribution to environmental objectives
2. Doing no significant harm to other environmental objectives
3. Complying with minimum social safeguards
4. Meeting technical screening criteria



The EU Taxonomy encompasses six environmental objectives, with detailed screening criteria established for climate change mitigation and adaptation. Starting last year, large listed companies began reporting on activities aligned with the taxonomy. This year, these companies are required to report on an additional four environmental objectives: circular economy, pollution prevention, biodiversity protection, and water resources [1].

Regulatory Compliance Overview

The 2023 Sustainable Finance Package has expanded the EU Taxonomy and proposed new regulations on ESG rating providers [3]. This framework merges with several regulatory requirements, including the Sustainable Finance Disclosure Regulation (SFDR) and MiFID II sustainability priorities [1].

Compliance involves a double materiality concept. Companies must show how their activities meet objectives and ensure they cause no harm to others [4]. This approach connects with the Principal Adverse Impacts (PAIs) under SFDR and affects data needs and operational requirements by a lot [4].

Building Data Management Infrastructure

The biggest problem banks face today is creating a resilient data management infrastructure to implement ESG and taxonomy frameworks. Research reveals that banks have general ESG strategies but don't deal very well with ESG data management [5].

ESG Data Collection Systems

ESG data encompasses various dimensions and requires metrics that range from energy consumption to workplace safety and diversity initiatives. This data should cover both operations and the value chain. The collection systems must be capable of handling:

- Internal operational data
- Upstream supplier information
- Downstream client portfolio metrics
- Unstructured data (PDFs, imagery, web scraping)

Recent studies show that all but one of these banks have started disclosing ESG risk data from a sample of 107. However, this information remains scattered in reports and formats [7].

Data Quality Control Measures

Strong governance will ensure the availability of high-quality data, which becomes increasingly important as regulatory scrutiny intensifies [5]. The quality control framework addresses a critical

statistic: only 24% of banks currently meet all qualitative disclosure requirements for each ESG risk [7]. Data integrity relies on standardized collection processes and associated controls, which help maintain consistency and accuracy while developing calculation procedures and documentation methods [8].

Integration with Existing Banking Systems

A centralized data platform integrates with finance and risk systems to establish a single source of truth [9]. Research indicates that concentrating on five or six cross-cutting ESG applications can provide 70% of the data and analytics required for an additional 30-35 use cases [6].

The platform architecture has four main layers:

1. **Data Sourcing Layer**: Ingests and processes metrics from internal and external sources
2. **Life Cycle Management Layer**: Organizes information around specific business topics
3. **Metrics Layer**: Captures and codifies KPIs centrally
4. **Use Case Layer**: Incorporates day-to-day functionality needs [6]

This integrated approach solves a common banking problem where ESG data sits in different departments without clear ownership [6]. These systems help us meet compliance requirements and build foundations for strategic advantage in sustainable banking.

Implementing Risk Assessment Protocols

Risk assessment protocols are grounded in a comprehensive understanding of ESG risks that influence banking operations. Furthermore, recent findings indicate that ESG risks now play a pivotal role in shaping the risk profiles and strategic approaches of over 80% of financial institutions [10].

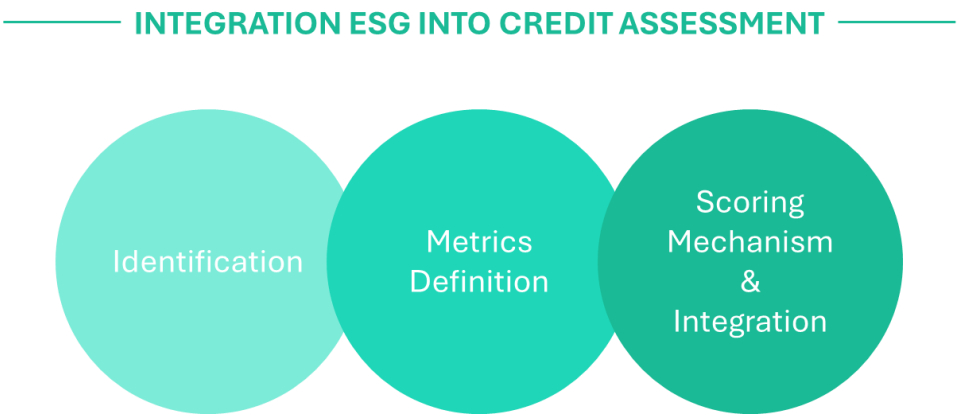
ESG Risk Evaluation Methods

The evaluation methods are structured around three core approaches:

- Physical risk assessment (extreme weather events, environmental degradation)
- Transition risk evaluation (carbon pricing, regulatory changes)

- Social and governance risk analysis (labor practices, ethical management)

Research shows that 70% of institutions face material risk within their three to five-year business plans [10]. A well-structured framework is now utilized, seamlessly integrating ESG risks with credit assessment through clearly defined scoring mechanisms and metrics [11].



Climate Risk Analysis Framework

A dual-lens approach is employed to address both immediate and long-term climate impacts. Physical risks require prompt action due to the increasing frequency of extreme weather events and environmental degradation. Simultaneously, the transition to a low-carbon economy introduces financial challenges through transition risks. Notably, many leading organizations report exposure to both categories of risks [12].

The framework is implemented through the following key steps:

1. Identify dimensions for ESG assessment based on business context
2. Define scoring mechanisms for evaluation
3. Integrate ESG with credit assessment
4. Implement monitoring systems

Risk Mitigation Strategies

An all-encompassing approach to risk mitigation is adopted, recognizing that ESG risks have the potential to disrupt operations across various divisions within the three lines of defense model. The

strategy integrates ESG considerations into existing risk frameworks while also developing specialized methodologies to address these risks effectively [13].

New guidance stresses the need for regular and thorough ESG risk materiality checks based on solid data and multiple methods [14]. Strong systems help gather ESG-related data efficiently. We use sustainability information from counterparties and work to improve data quality [14].

ESG factors are now an integral component of the standard risk management framework. A robust approach is employed across short-term (3 years), medium-term (5 years), and long-term (10 years) horizons. This comprehensive effort spans the three lines of defense, encompassing elements such as risk appetite, internal controls, and capital adequacy assessments [14].

Developing Sustainable Product Strategies

The growing demand for sustainable products underscores the need for an expanded green product portfolio aligned with EU taxonomy objectives. Recent data indicates that nearly 40% of U.S. consumers express significant interest in climate-linked financial products, highlighting a compelling case for the development of innovative green banking solutions [15].

Green Financial Products Design

A comprehensive suite of green financial products is being developed to meet taxonomy requirements. The product portfolio includes:

- Green bonds for environmental projects
- Sustainability-linked loans with ESG performance metrics
- Transition financing for green practices
- Green mortgages for energy-efficient properties
- Climate-screened index funds [16]

Research indicates that customers are willing to pay premium prices for sustainable products. Approximately 40% of consumers opt for green savings accounts, even when the annual percentage yield (APY) is 20% lower than that of traditional accounts [15]. These findings demonstrate the effectiveness of the sustainable product strategy in the market.

Impact Assessment Metrics

A robust framework has been established to evaluate the success of sustainable products, assessing both financial impacts and broader outcomes for stakeholders [17]. Research indicates that two-thirds of customers prefer engaging with their bank on sustainable initiatives rather than working directly with service providers [15]. This underscores the importance of maintaining a comprehensive understanding of the overall impact of these initiatives.

Banks have put substantial resources into developing sustainable offerings, which has helped raise billions in ESG investments [18]. The impact is tracked through:

1. Quantifiable environmental benefits
2. Social impact indicators
3. Governance improvement metrics
4. Taxonomy alignment scores

Market Opportunity Analysis

The sustainable banking products market shows great growth potential. It reached USD 5.4 trillion in 2023 and should grow at a CAGR of over 22% between 2024 and 2032 [19]. Renewable energy investments make up 30% of sustainability holdings but only 8% of ESG-aligned funds [20].

Customer demand remains strong across segments. Two in three consumers want to put more than 40% of their savings or monthly credit card spending into green retail banking products [15]. Middle-market customers demonstrate a strong interest in sustainable solutions, and the focus is on becoming their trusted advisors to support their transition to green practices [21].

Creating Governance and Reporting Structure

A robust governance and reporting structure serves as the foundation for integrating ESG principles and the taxonomy. Recent data indicates that 50% of large banks now employ an ESG controller to manage mandatory ESG-related disclosures [22]. This trend highlights the increasing importance of structured oversight in today's financial landscape.

ESG Governance Framework

A comprehensive governance framework has been established to align with evolving regulatory requirements. Research shows that the majority of large banks (9 out of 11) now have a Head of Sustainability or Chief Sustainability Officer overseeing their ESG strategy [22]. The governance structure includes:

- Board-level ESG Committee oversight
- Dedicated ESG management team
- Cross-functional steering committees
- Clear reporting lines and responsibilities
- Risk and compliance integration

Typically, an ESG team consists of 15-20 professionals working across various functions, ensuring thorough coverage of all sustainability aspects. Annual investments range from CHF 0.89 million to CHF 4.45 million to enhance ESG disclosure capabilities [22].

Reporting Mechanisms

The reporting framework is designed to meet both CSRD and EU taxonomy requirements, utilizing a double materiality approach that examines the impact of environmental changes on the business as well as the effects of operations on the environment [23].

The following key steps ensure the delivery of accurate and detailed reports:

1. Data collection and validation
2. Materiality assessment
3. Performance metric tracking
4. External verification
5. Regulatory compliance review

A commitment to transparent ESG reporting is upheld, ensuring the provision of clear, accurate, and detailed information on environmental, social, and governance performance. This transparency fosters credibility and trust with stakeholders while demonstrating a strong commitment to sustainability [24].

Stakeholder Communication Channels

Stakeholder engagement is a two-way process, where information is shared, and feedback is actively sought. The communication strategy reaches various stakeholder groups through multiple channels. Research indicates that stakeholder engagement not only helps meet ethical standards but also drives long-term success [25].

New digital platforms provide real-time updates on ESG performance through interactive dashboards and data analytics tools, aligning with the commitment to transparency and accessibility. Stakeholders are kept informed through:

- **Direct Engagement:**
  - Quarterly meetings
  - Annual sustainability reports
  - Town hall discussions
  - Focus group sessions

- **Digital Channels:**
  - Interactive ESG dashboards
  - Real-time performance updates
  - Social media communications
  - Dedicated ESG portal

This detailed structure enables the organization to meet the increasing expectations for ESG disclosures while remaining aligned with EU taxonomy objectives. Plans are in place to soon increase investment in governance and reporting infrastructure to CHF 8.91 million. This investment underscores a strong commitment to leading sustainable banking practices [22].

FORFIRM's Approach

FORFIRM's approach for integrating ESG (Environmental, Social, and Governance) principles and Taxonomy compliance in banking operations involve the following structured steps:

1. Quantify Baseline Carbon Footprint: establish the starting point for carbon emissions from the bank's operations and portfolios, through the following activities:

- Conduct a carbon inventory for both direct (Scope 1) and indirect (Scope 2 and 3) emissions.
- Utilize tools like the GHG Protocol and data sources such as energy bills, employee travel records, and financed emissions of investments.
- Use emissions factors databases like DEFRA or ecoinvent to quantify emissions.
- Perform data quality assessments to ensure accuracy and completeness.

2. Apply Scenario Analysis of Financial Impact of Climate-related Risks: understand and prepare for potential financial risks posed by climate change, through the following activities:

- Identify risks: Categorize them into physical risks (e.g., natural disasters) and transition risks (e.g., policy changes).
- Use scenario analysis frameworks such as those provided by the TCFD (Task Force on Climate-related Financial Disclosures).
- Evaluate best-case, mid-case, and worst-case scenarios considering global temperature pathways (e.g., 1.5°C, 2°C scenarios).
- Assess impact on credit, market, operational, and reputational risks.

3. Climate Data Intelligence and Carbon Management Projects: use advanced analytics and management practices to make informed decisions about climate strategies, through the following activities:

- Implement data intelligence tools for gathering, analyzing, and visualizing ESG-related metrics (e.g., AI for predictive modeling).
- Conduct carbon reduction projects, such as energy efficiency improvements, renewable energy adoption, and green financing programs.
- Develop partnerships with third-party providers for enhanced climate data insights.

4. Set Targets: define short-term and long-term ESG goals aligned with science-based targets and industry standards, through the following activities:

- Set targets in alignment with frameworks like the SBTi (Science-Based Targets initiative) or Net-Zero Banking Alliance.
- Differentiate between absolute and intensity-based targets.
- Incorporate interim milestones to track progress and maintain accountability.

5. Reporting Based on Metrics and Scenarios: provide transparent and structured reporting to stakeholders, regulators, and investors, through the following activities:

- Align reporting practices with recognized standards such as GRI (Global Reporting Initiative), SASB (Sustainability Accounting Standards Board), or EU Taxonomy.
- Disclose scope emissions, risk analysis outcomes, and progress toward targets.
- Use ESG dashboards for internal tracking and external reporting.
- Address emerging regulatory requirements for taxonomy compliance, such as EU Sustainable Finance Disclosure Regulation (SFDR).

Conclusion

Banks have significantly transformed their sustainable practices through the adoption of ESG criteria and taxonomy frameworks. A closer examination reveals how these principles enable banks to establish robust systems that not only meet regulatory requirements but also create enduring value for stakeholders.

The Key Areas Defining Modern Sustainable Banking:

- ESG-Taxonomy Integration Frameworks: Aligning with EU objectives and regulatory requirements.
- Advanced Data Management Systems: Ensuring accurate, detailed information gathering and processing.
- Comprehensive Risk Assessment Protocols: Effectively addressing physical, transition, and ESG-related risks.
- Sustainable Product Strategies: Meeting the growing demand for environmentally responsible financial products.

- Transparent Governance Structures: Facilitating clear reporting and effective stakeholder communication.

These elements together create a banking system that aligns environmental objectives with business goals, enabling institutions to lead in sustainable finance while effectively managing risks.

The sustainable finance market continues to expand, driven by evolving regulatory landscapes and increased stakeholder demand for environmental responsibility. Research highlights new opportunities for banks that integrate ESG criteria and taxonomy principles into their operations.

FORFIRM can play a critical role in this transformation, supporting banking partners in the seamless integration of ESG and taxonomy frameworks. By leveraging FORFIRM's expertise, banks can enhance risk management, improve transparency and compliance with ESG standards, and adopt proactive climate strategies for long-term value creation.

This shift represents more than compliance—it is a fundamental move toward responsible finance that benefits society and businesses alike. By embracing these frameworks, banks build resilient operations prepared for future challenges while contributing meaningfully to environmental sustainability.

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