Developing Sustainable Finance Definitions and Taxonomies

A BRIEF FOR POLICY MAKERS

The momentum around sustainable finance taxonomies

In recent years, investors have increasingly taken actions to integrate climate change and broader sustainability concerns into their investment decisions and portfolio allocations. However, there is a widely perceived need for greater certainty on the environmental sustainability of different types of investments and economic activities. In response, a number of jurisdictions have started to legislate to create official definitions of sustainable finance. This report maps sustainable finance definitions and taxonomies in five jurisdictions: the EU, China, Japan, France and the Netherlands.

Taxonomies are definitions of sustainable finance that aim to be comprehensive classification systems, while definitions of sustainable finance are less ambitious in scope. When appropriately designed, sustainable finance definitions and taxonomies can bring potential benefits. These include improving market clarity. More precise and consistent definitions of which investments are "green" and "sustainable" could facilitate investment by giving confidence and assurance to investors. Other potential benefits include easier tracking of sustainable finance flows to be able to measure them or to take a policy action such as setting incentives.

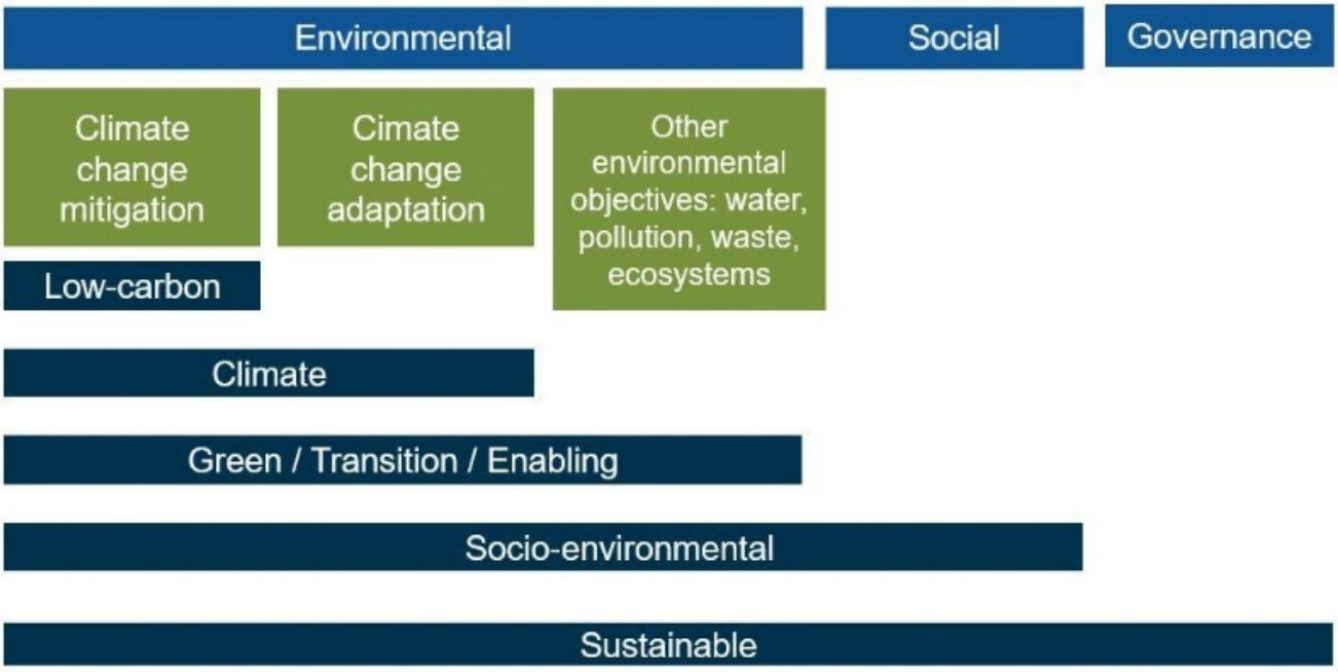
Recognising some of those potential benefits, the European Union (EU) adopted a regulation in June 2020 to establish a framework to facilitate sustainable investment. This regulation, often referred to as "the EU Taxonomy Regulation", is the cornerstone of the EU Sustainable Finance Action Plan, as it will feed into several forthcoming regulatory initiatives such as the EU Green Bond Standard, the EU Ecolabel for retail investment funds and others.

Several other jurisdictions also have addressed sustainable finance taxonomies and definitions. In China in 2015, the People's Bank of China issued the first iteration of its Green Bond Endorsed Project Catalogue, commonly referred to as "the Chinese taxonomy". In Japan in 2017, the Ministry of the Environment of Japan (MOEJ) launched Japan's green bond guidelines. The Netherlands has had a legislative approach to green lending since 1995 (Green Funds Scheme), and France created the GreenFin label for retail investment funds in 2015. Other countries expressing interest on sustainable finance taxonomies include Canada, Kazakhstan and Indonesia, among others.

Policy makers have diverse options to design taxonomies

Taxonomies or definitions (henceforth "taxonomies") can cover a diverse range of environmental objectives, from climate mitigation to a broader set of environmental objectives (adaptation, water, circular economy, pollution, biodiversity, or others), and can include social and governance objectives (or not do so). Taxonomies can also have diverse "colours". For example, they may identify economic activities or financial products that are already compliant with environmental objectives ("green" or "dark green"). Additionally or alternatively, they may identify activities that are on a transition pathway to become green ("transition" or "light green").There may be a role for "brown taxonomies" as well, i.e. taxonomies identifying activities which are not judged compatible with environmental objectives.

Sustainable finance taxonomies can have multiple objectives



An additional design consideration is the incorporation of the notion of a systems approach. Based on the OECD contribution to the EU Technical Expert Group on Sustainable Finance (TEG), the EU taxonomy recognises that an economic activity cannot be considered truly sustainable independent of the wider system in which it operates. An equally important design consideration is the need to reflect multiple pathways. There are many potential pathways to a given emissions objective, and different jurisdictions will have different long-term climate policy objectives and will follow different pathways. How pathways are translated to the level of a corporate issuer is also a topic for careful consideration. Taxonomies should also be adaptable to evolving knowledge and technologies as well as the adjustment of transition pathways in view of results achieved over time.

The introduction of government-sponsored taxonomies may significantly increase demand for data from issuers and investors in order to check eligibility of activities and/or investments. The issue of data availability is central to the uptake of taxonomies. The implementation of taxonomies requires a degree of standardisation of the data provided, to allow for aggregation and assessment of compliance in a way that is consistent and comparable.

A related consideration is the likely "ease of use" of a taxonomy. This issue is particularly important at present, notably for smaller operators, when economies worldwide are already coping with economic and financial impacts and pressures created by COVID-19 response measures. Overstretched financial and human resources could impede implementation of new frameworks. Making taxonomy compliance achievable for smaller corporates and financial market participants could involve, for example, using a proportionality approach when designing compliance and verification criteria.

Mapping taxonomies in five jurisdictions: commonalities, differences and gaps

Among the taxonomies and definitions examined in this report, the EU taxonomy is unique in the level of detail of its compliance requirements. It also is the only framework in which six environmental objectives are interlinked through the multi-dimensional "Do No Significant Harm" (DNSH) requirement. These six environmental objectives are climate change mitigation, climate change adaptation, water, circular economy, pollution and biodiversity. Keeping in mind these essential differences, commonalities among the taxonomies can be identified for renewable energy and green buildings, where metrics and thresholds among the scoped definitions are similar. By contrast, in other sectors such as non-renewable power generation and transport, international investors will find that sectoral coverage is similar across jurisdictions but criteria for inclusion differ. Only the EU taxonomy includes certain hard-to-abate manufacturing sectors such as cement, steel, aluminium and hydrogen. Finally, some gaps in terms of sectors not covered can be identified in all frameworks, including the aviation and health sectors.

Many issuers and investors have activities and investments across several jurisdictions. A taxonomy reflecting only a single jurisdiction and its associated activities will not allow issues and investors to cover all of their international activities or investments. To resolve this issue, the TEG has identified certain criteria in the EU taxonomy as being of "international relevance", meaning that users of the taxonomy could use them for economic activities located outside the EU. Other issues around international comparability of taxonomies are discussed in the International Platform on Sustainable Finance (IPSF), launched by the EU in 2019 to enhance international cooperation. The OECD is an observer to the IPSF.

Towards a common understanding of what sustainable means

Well-designed taxonomies can help policy makers to develop and grow sustainable finance markets to support the achievement of environmental and other sustainable development goals. However, the complexity of and differences among taxonomies can create challenges for investors, particularly international investors. Commonalities across different taxonomies could provide a basis for creating comparable frameworks that facilitate international investment while also reflecting differing national circumstances and approaches.

Sources, incentives and objectives in sustainable finance definitions and taxonomies considered in the report

	China Taxonomy	EU Taxonomy	France Definitions	Netherlands Definitions	Japan Definitions
Sources					
Sovereign Green Bond			✓	✓	
Green loans definitions in legislation	✓	✓	✓	✓	
Green bonds definitions in legislation	✓	✓	✓	✓	✓
Incentives					
Interest rate incentives	✓		✓	✓	
Tax incentives or subsidies	✓		✓	✓	✓
Monetary policy/collateral incentives	✓				
Objectives					
Social objectives included	✓	✓	✓		
Climate change adaptation		✓	✓	✓	✓
Climate change mitigation	✓	✓	✓	✓	✓
Water and marine protection	✓	✓	✓	✓	✓
Pollution prevention and control	✓	✓	✓	✓	✓
Waste and recycling	✓	✓	✓	✓	✓
Ecosystems/Biodiversity	✓	✓	✓	✓	✓

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BETTER POLICIES FOR BETTER LIVES

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