5 Preliminary reflections on policy considerations relevant to sustainable finance definitions and taxonomies

This chapter proposes initial policy considerations relevant to the design of sustainable finance taxonomies by policy makers. For instance, taxonomies can deal with economic activities, or with financial products. They can cover a variety of environmental objectives. They can target different "shades of green", ranging from activities that are already aligned with environmental objectives, to transition activities, even to "dirty" activities at the opposite end of the spectrum. The stringency of criteria, geographical scope, and adaptability to innovation are additional examples of design considerations.

This chapter proposes elements for policy makers to consider in relation to the design and implementation of sustainable finance taxonomies and definitions. In the rest of this section, references to "taxonomies" should be understood as referring to both taxonomies and definitions – i.e. policies, regulations or official guidance defining sustainable finance activities or products comprehensively in a given jurisdiction[1]. Gathering and expanding ideas from previous sections, this section puts forward a preliminary set of issues for examination in future research. This future work will aim to provide evidence-based research to support policy makers' efforts to design and implement sustainable finance taxonomies. In the meantime, this section can serve as an initial checklist of issues and options for policy makers to consider.

5.1. Taxonomy design issues: role of taxonomies in the achievement of environmental policy objectives

5.1.1. Overarching objectives of a sustainable finance taxonomy

The design of a taxonomy will depend on its objectives. One objective may be to help the flow of investment capital to a sustainable economy, with the definition of "sustainable economy" influencing the taxonomy design (see discussion below on "environmental objectives"). An additional objective may be to increase market confidence by avoiding green washing. A third objective may be to measure the stocks or flow of sustainable investments in the economy to assess them against specific objectives (e.g. "two-degree alignment"). Taxonomies can also be used as a basis to develop a system of incentives for sustainable finance. Such incentives can be designed in monetary policy (such as lower refinancing rates for banks on green lending, a policy implemented in China). They can be designed in fiscal policy (such as reduced tax rates on green loans, a policy in the Netherlands), or in financial policy (such as interest rate reduction for green loans, also in place in the Netherlands).

5.1.2. Sustainable finance economic activities versus sustainable financial products

The EU has chosen to establish a taxonomy for economic activities based on NACE codes. By contrast, some other jurisdictions such as China and the Netherlands have established taxonomies based on sustainable finance products (such as green loans or green investment funds). In the EU, future legislation will be developed to reference the EU Taxonomy in sustainable finance products definitions such as green investment funds (EU Ecolabel for retail funds and EU Green Bond Standard). Not all issuers or investors in the EU have been using the NACE code framework, so the use of this framework will require some adaptation by the market that will be key to the fast and successful implementation of the EU taxonomy.

5.1.3. Environmental and other objectives

A taxonomy can cover many objectives. They range from climate mitigation to other environmental objectives -- such as climate adaptation, circular economy, sustainable use and protection of water and marine resources, waste prevention and recycling, pollution prevention control and protection of healthy ecosystems -- to social and governance objectives, as in the EU taxonomy. Such objectives can be considered as independent (such as in China), or can be interlinked, as in the EU, based on the concepts of substantial contribution and do no significant harm.

The scope and level of ambition of the taxonomy will influence its complexity, the costs of implementation and supervision and the ease and pace of uptake by the market. In these respects, the beginning of market implementation of the EU taxonomy in the coming months will provide opportunity for market feedback. The EU taxonomy will be referenced in several forthcoming regulations or directives at EU level, including the EU Green Bond Standard, the EU Ecolabel, the revised Non Financial Reporting Directive and others. The introduction of the taxonomy in these frameworks will influence the way issuers and investors report

on environmental sustainability and will enable to assess the effective complexity, costs and opportunities of providing taxonomy alignment related data.

Further issues for consideration include ways to design a "social" taxonomy, or to design social dimensions to a taxonomy also covering environmental issues. The EU is the only jurisdiction in the scope of this report that has attempted to incorporate social issues using a "minimum safeguards" approach based on existing international frameworks such as the OECD MNE guidelines, ILO and UN conventions. Other approaches could be envisaged bringing focus on specific social goals such as gender equality or others.

5.1.4. "Binary taxonomy", "transition" and "brown taxonomies"

Taxonomies in scope of this report attempt to identify what is sustainable or green. By doing so, they serve as an instrument for identifying investment opportunities. Beyond opportunities, issuers and investors also are increasingly focused on the risks posed to their activities and performance by climate change and other sustainability issues such as biodiversity loss. Therefore, a "brown taxonomy" identifying which activities are detrimental to sustainability objectives, could be useful from a risk perspective. It also would be useful to investors seeking to shift their investments away from activities that are less environmentally sustainable. The EU has indicated that it would consider developing a brown taxonomy and provide a first report on a taxonomy for environmentally harmful activities by the end of 2021.

Another way to design a taxonomy could be to provide a comprehensive, "multi-colour" screening system that would enable the ranking of a whole portfolio from "pure green" to "dark brown", and any activities that might be characterised by other colours (e.g. those with ambiguous or no climate implications, such as the health or media sectors). The EU approach remains a binary approach (economic activities are either compliant with the sustainability standard or they are not). However, "transition" and "enabling" activities have been included in the framework. The EU taxonomy therefore aims to include not only activities that are already "green", but also activities which are on a transition pathway, and activities enabling others to exist such as essential parts of their supply chain. . The link of taxonomies to transitions also needs to be framed within a systems approach that allows for multiple pathways.

5.1.5. Systems approach

Based on the OECD contribution to the TEG, the EU taxonomy incorporates the notion of a systems approach to economic activities. This approach recognizes that an economic activity cannot be considered truly sustainable independent of the wider system in which it operates. For instance, the contribution of electric vehicles to environmental sustainability should be assessed not only against their own emissions characteristics, but also against the wider benefits that they may or may not provide in terms of traffic congestion, within a transport system that takes into consideration land use and alternative mobility options. Consistent with this notion, the taxonomy identifies activities that make a substantial contribution on their own but also enable the overall transition of critical systems such as the energy, transport, urban, water and food systems. A taxonomy-eligible activity may only contribute to an individual country or region's transition pathway when it is also coherent with the transition of the overall system of which the activity is a part. Awareness of systems issues on the part of market actors and policymakers can and should lead to innovation, new thinking on eligibility criteria for certain activities, and updated criteria .

5.1.6. Integrating pathways in the design of taxonomies

The EU taxonomy screens a number of activities based not only on a threshold to meet today, but also on a future trajectory that the activity must follow in order to reach the sectoral, climate and environmental objectives agreed at EU level. The policy objective referenced most often in the current version of the EU taxonomy is reaching carbon neutrality by 2050. Other jurisdictions have different long-term climate policy objectives and will follow different pathways, which could be reflected in their sustainable finance

definitions and taxonomies. Integrating pathways into definitions and taxonomies can help avoid lock-in of emitting activities and assets, and help ensure that eligible investments will be compatible with long-term policy objectives. However, pathways have a number of complexities and raise several issues. One is that there are many potential (global) emissions pathways to a given goal. Choosing one of them for the taxonomy requires careful consideration of implications. A second issue worth considering here is that different countries will opt for different transition pathways. A third issue is that if a pathway can be identified for a given economic activity, an approach is still needed to translate the pathway or pathways to the level of a corporate.

5.1.7. Stringency of criteria

The choice of stringency in thresholds is a key element in the design of a sustainable finance taxonomy. Less stringent thresholds favour the uptake of a taxonomy by issuers of green financial products, for whom it will be easier to find taxonomy-compliant projects. Thresholds that are more stringent may give more confidence to investors in asserting the environmental benefits of their investments. They also may channel capital faster to ambitious green activities (but perhaps less capital overall than would be channelled by less stringent thresholds).

5.1.8. Adapting to innovation and technology developments

A taxonomy should be able to adapt to the emergence of new technologies. Consequently, a challenge of designing a taxonomy is the need to ensure sufficiently frequent updates to minimise any lag behind market innovation. Setting ambitious thresholds in a taxonomy framework can itself spur innovation, by inciting corporates to better their environmental performance to match the threshold.

5.2. Role of taxonomies for issuers and investors: Taxonomy usability and implementation issues

5.2.1. Geographical scope

In today's globalised economy, underpinned by global financial systems, many issuers and investors will have activities and investments across several jurisdictions. A taxonomy reflecting only a single jurisdiction and its associated activities will not be sufficient to enable issues and investors to cover all of their international activities or investments. In order 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. Criteria for sustainable forest management, for example, are designated as being of international relevance[2].

For some sectors, there is no consistency between various taxonomies, as the mapping in section 4 suggests. For instance, the manufacturing of cement and steel would be eligible under certain conditions in the EU Taxonomy, and not in other taxonomies considered in this report. There are differences between taxonomies on environmental objectives and the link between them, sectoral coverage, thresholds and exclusions. The EU has sought to address this in part by having some criteria of international relevance. It has also set up the International Platform on Sustainable Finance (IPSF) as a platform to exchange and disseminate best practices in environmentally sustainable finance, to compare different initiatives and identify barriers and opportunities to help scale up environmentally sustainable finance internationally. The Platform also aims at enhancing international cooperation where appropriate, while respecting national and international contexts. Cooperation creates the potential for reducing differences.

5.2.2. Data availability

The introduction of government-sponsored sustainable finance 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. Just as there are many different definitions of green finance, there is also a variety of methodologies for reporting certain metrics, such as carbon emissions. According to how taxonomies and other sustainable finance regulations, such as disclosure requirements, are designed, data may need to be provided by issuers (including corporates), by investors, or by both. Data may be provided by issuers' and investors' in-house resources, or by third-party specialized data provision firms, to which issuers and investors outsource data production.

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. The extent of this need for data, and possible gaps compared to presently available data, depends on the design of the taxonomy. While the production of data will absorb financial and labour resources, it is necessary to enable the assessment of investors or issuers against sustainability objectives. There could be important trade-offs in terms of uptake of taxonomies if taxonomy design leads to persistent data needs and gaps. Active and ongoing efforts by various initiatives (e.g. by the Principles for Responsible Investment, PRI, or the United Nations Environmental Programme Finance Initiative, UNEP FI) to test how the EU taxonomy will be implemented by users, will help to identify challenges with respect to data availability.

5.2.3. Data verification

Compliance with sustainable finance taxonomies may need to be verified by third parties. Such third parties may be accredited professional verifiers, such as is envisaged for the EU Green Bond Standard. Market supervisors and regulatory authorities may also play a role in the supervision of implementation of taxonomy frameworks. The existence of taxonomies in itself is no guarantee that greenwashing will not take place, because financial market participants or corporates could report compliance inaccurately. Therefore, the quality of the verification process of a taxonomy will be particularly important to reduce the risk of green- and impact-washing, and thereby to provide confidence that will enable market growth. The nature of data certification and verification is also a determinant of the liability risks associated with inaccurate data provision, and potentially with investments made on the basis of sustainable finance credentials. Data verification is therefore an important part of the architecture and implementation of taxonomies.

5.2.4. Usability

The likely "ease of use" of a taxonomy for its intended users is an important consideration when designing a taxonomy. This is particularly true at present, when economies worldwide are coping with economic and financial impacts and pressures created by COVID-19 response measures, and financial and human resources may be constrained to incorporate new frameworks. In the case of the EU taxonomy, a degree of complexity results from the use of economic activities and NACE codes as the core structure of the taxonomy, because NACE codes are not always consistent with accounting frameworks used by corporates. Another degree of complexity derives from the EU's ambition to interlink six environmental objectives together through the "do no significant harm" approach, thereby requiring six types of assessment for every single economic activity. The EU taxonomy has not yet been implemented in practice, and important considerations in terms of usability will come out of its effective implementation. A related consideration for taxonomy design is to involve final users at an early stage in the legislative process. Several consultations are now on going at EC level to that effect regarding the EU taxonomy.

5.2.5. Proportionality

Sustainability objectives need to be embedded across the global economy, not only for large issuers and investors but also for smaller operators. An important usability consideration is to make taxonomy compliance achievable for smaller corporates and financial market participants. This may involve using a proportionality approach when designing compliance and verification criteria. The Netherlands for instance has developed successfully green loans and funds schemes tailored to retail markets and small businesses, including not only specific incentives for small-sized operation but also a distribution system involving retail banking networks.

Notes

[1] This excludes definitions that do not apply beyond a single instrument such as a green bond or a green investment fund.

[2] Please refer to paragraph 289 in the Annex regarding EU taxonomy forestry criteria.