



FAIR FINANCE ASIA

MODULE 2

**DEVELOPING AND DECIDING ON A TAXONOMY
FOR SUSTAINABLE FINANCE**



About this guidebook

This guidebook, commissioned by Fair Finance Asia (FFA), is made up of four separate modules, designed specifically for Asian civil society organizations (CSOs) that are interested to learn about frameworks and taxonomies for sustainable finance, and how to optimally leverage them when promoting greater transparency and accountability in the financial sector.

The guidebook was developed using all publicly available data and information as of end of January 2022.

About Fair Finance Asia

Fair Finance Asia (FFA) is a regional network of civil society organizations (CSOs) committed to ensuring that financial institutions operating in Asia respect and uphold the rights and social and environmental well-being of local communities.

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The way a taxonomy is developed, ultimately decided upon and who is involved in these processes all have an important impact on how a taxonomy is formulated.

This module explains the different aspects of the process. Each aspect is important to consider when assessing the quality and effectiveness of a new or existing taxonomy. This overview will also provide insights into strategies and ways to influence the decision-making process.



1. WHY DEVELOP A TAXONOMY?

There are different motives and reasons for developing a taxonomy. Typically, the development of a taxonomy is announced as part of a policy to orient more money towards meeting the Paris climate goals and/or the SDGs.

Trillions of dollars are needed to achieve these goals, and private sector funds will need to complement public funds. However, the private sector has been reluctant and slow to reorient financing, notwithstanding many promises, and has ignored the impact of its financing. China and the EU have been developing a taxonomy for several years, and international discussions have motivated more countries to adopt a sustainable finance policy with a taxonomy.

For the financial industry, public financial institutions and government, a taxonomy is a tool to clarify, harmonise and facilitate the activities, projects and companies to finance in order to have a positive impact on climate mitigation and adaptation, environmental resilience, social impact or sustainable development.

The most common reasons for a taxonomy in the financial sector are:

- **Harmonisation and standardisation** of the many definitions that have been used by the financial industry, by official bodies such as multilateral development banks or for financial products, such as green/social/sustainable bonds to ensure that everyone is using the same definition and not employing misleading or ineffective definitions.
- **Avoiding false claims** (“greenwashing”) about the positive impact of the activities, projects or companies. Quite often, investments, investment products and loans that claim in their marketing to have positive impacts are not actually contributing to improvements (but are generating a profitable

financial return). In other words, there is significant misselling of investment products (e.g. a green investment fund that contains shares of oil companies). Clear definitions help regulators to avoid misselling and financial authorities to sanction more easily.

- **Lack of comparability** between different activities, projects or companies that claim to have positive contributions. This makes it difficult and costly for investors and lenders to identify the most positive activities, projects and companies to finance. Comparability makes it much easier and more attractive for foreign investors to finance taxonomy-aligned products. In other words, a taxonomy helps to **reduce costs, support greater profitability** for investors and lenders and **increase (cross-border) interoperability**, thereby facilitating more financial flows to meet the objectives of the taxonomy.
- **Increasing the transparency of financial flows** to the taxonomy’s objectives in case the taxonomy is used for reporting, for example, the proportion of an institutional investor’s portfolio or an investment fund that is financing activities, projects or companies which are in alignment with the taxonomy.
- **Authorities that want an overview of, and to monitor**, how much or how little the taxonomy objectives are being financed (compared to estimated financial needs) can gather reports on taxonomy-aligned financing. Also, government bodies can use the taxonomy to select activities, projects or companies to be subsidised or financed to achieve particular climate, environmental, social or sustainability policy objectives.



REMARKS

- Many (FFA) countries are already developing sustainable finance policies, as well as some financial regulations, to encourage more investments and lending that contribute to achieving the SDGs or the Paris climate goals. Developing a taxonomy has become one of the measures in the development and implementation of these sustainable finance strategies.
- Many countries already have similar instruments in place, such as lists of potential activities that can be financed by green, social or sustainability bonds, or requirements for corporate social responsibility (CSR).

2. WHO IS INVOLVED IN DRAFTING A TAXONOMY?

Who drafts the blueprint of the taxonomy is important as it often determines the objectives, whether the taxonomy is general or prescriptive and what it will cover. It might be difficult to completely overhaul the outline of a first draft taxonomy during subsequent processes.

There are different authorities, bodies, associations, fora or platforms, or even consultants from inside or outside the country or the region, that work on the first draft of a taxonomy.

2.1. WHO IS INVOLVED AT THE COUNTRY LEVEL?

The following groups have been involved in the first drafts of taxonomies in various countries:

- **Financial authorities:** The country's central bank (e.g. Bank Negara Malaysia), as a regulator and supervisor of banks and other financial sectors, or other financial regulatory and supervisory authorities (e.g. OJK in Indonesia), can begin to determine the general objective and outline of the taxonomy and draft the first text.
- **Government agencies:** The Ministry of Finance can begin the process of developing a taxonomy. It can also be a platform of different ministries (e.g. including the ministries of environment and economy) and government agencies (e.g. national statistics agency) that cooperate and discuss among themselves during the drafting of the taxonomy. Examples are the Sustainable Finance Collaborative in India and the Inter-agency Working Group on Sustainable Finance in Thailand.

Government agencies can rely on consultants to do the actual drafting with terms of reference from the government or cooperation platform.

- **Financial sector associations:** Given that the private financial sector wants a taxonomy to facilitate identification, comparability, and (international) investment products and financial flows, a national or international bank or investment association can begin the process of developing a taxonomy. Such an association can also link up with other actors in the financial sector, including financial authorities (e.g. the Green Finance Industry Taskforce in Singapore), and become a multi-stakeholder initiative.
- **Multi-stakeholder initiative:** A governmental body, financial authority or private financial sector, might bring together different stakeholders from various sectors in the economy, society and/or the government to discuss and draft the taxonomy. Such multi-stakeholder discussions can also be done at different stages of the drafting process. For example, after the terms of reference or general outline have been finalized by the body that has called for a multi-stakeholder initiative, or to work out details, such as applying the screening criteria to different sectors.



WHY IS IT IMPORTANT TO KNOW WHO IS INVOLVED?

Each group involved in the drafting process might have different motives and interests. Financial authorities might be more willing than private financial sector initiators to come up with strict definitions to avoid greenwashing as well as financial instability from financial losses and devaluation of activities, projects or companies following damage from climate change or other sustainability issues (i.e. “stranded assets”). On the other hand, government ministries and the private sector might be more interested in starting with a general taxonomy to incentivise more financing for green or sustainable activities, projects and companies without overly prescriptive requirements.

Potential non-governmental stakeholders include representatives of different sub-sectors of the financial sector (all kinds of investors, banks and insurance companies) and sub-sectors from the mainstream economy (this might even include fossil fuel-based sectors), consultancy and accounting sectors, trade unions, academics, consumer organisations and CSOs. There might be a difference between members who can vote and observers who can contribute their expertise. Some governmental bodies might also attend as members or observers, such as national financial authorities or international organisations (e.g. UNDP or a multilateral development bank).

2.2. WHO ELSE HAS A SAY? INFLUENCES FROM OUTSIDE THE COUNTRY

The various phases of taxonomy development can also be influenced from authorities and processes from outside the country. Some of the following groups may participate in the initial phases in FFA countries:

- **Advisors and consultants:** The drafting or coordination of a first version of a taxonomy can be led by consultants or with the support of advisors from outside the country. Consultants from consultancy firms, multilateral international organisations (e.g. UNDP, IFC) or private expert organisations (e.g. Climate Bond Initiative/CBI) can be hired by the initiators or funded by a donor. In different FFA countries (e.g. Thailand, Philippines, India), donors have made funding agreements with the central bank or the Ministry of Finance to

develop a sustainable finance policy that includes the development of a taxonomy. Donor countries are interested in other countries adopting taxonomies similar to their own to facilitate comparability and cross-border interoperability.

- **Cooperation and exchanges:** Countries that are developing a taxonomy can learn from those that have already developed one, or are in the process of doing so, and share information at bilateral or international meetings. Such exchanges might be initiated or supported by international organisations or platforms (e.g. meetings and documents by the SBFN). When a taxonomy is initiated by the private financial sector, it might be drafted in cooperation with external private financial sector participants (e.g. UK-India Sustainable Finance Working Group and Singapore's Green Finance Industry Taskforce is comprised of representatives from several foreign banks and investors).
- **Supra-national bodies:** Where there are regional governance structures of the financial sector (e.g. in the EU) or in regions where countries cooperate, regional bodies can take the initiative to draft a regional taxonomy or a common foundation for a regional taxonomy that allows national specificities (e.g. ASEAN). The world's various multilateral public banks have identified and developed criteria and lists of activities/projects (i.e. taxonomies) for finance that has a positive sustainability impact. They have been cooperating to harmonise their taxonomies and influencing other taxonomy developments.



CHALLENGES

- The first draft of a taxonomy often happens behind closed doors with only a few powerful or influential groups participating in the early stages (e.g. India's taxonomy working group's members of the Sustainable Finance Collaborative). This makes it difficult for parliamentarians and civil society to influence a taxonomy during these important initial drafting stages.
- Multi-stakeholder groups drafting a taxonomy face a variety of challenges. Ideally, a variety of stakeholders are involved in a balanced way, including non-financial sector experts such as academics, CSOs and NGO experts, and trade unions, and arrive at a balanced outcome or "lowest common denominator" compromise. If stakeholders are imbalanced in terms of numbers or their capacity to participate, especially when industries that would lose from a quick transition are participating, the outcome can be in favor of vested interests. That is, the taxonomy may have general principles and definitions with little screening criteria so that many activities, projects or companies can continue to be financed. Also, multi-stakeholder initiatives may take a long time or encounter challenges in reconciling opposing and various views. The result might be a taxonomy that is not effective at achieving climate, environmental, social or sustainability goals.

- International and regional harmonisation efforts:**
 To avoid having many different taxonomies around the world, international bodies (e.g. G20, IPSF) are discussing and developing common characteristics of a taxonomy (e.g. using the same statistical method to identify the sectors covered by the taxonomy). Internationally identified common elements can influence the drafting of national taxonomies. It is argued that taxonomies that have international or regional commonalities can attract more foreign “sustainable” finance.
- International financial sector lobby organisations:**
 These organisations often have the capacity to put pressure on bodies that are initiating a taxonomy. They often aim to prevent overly prescriptive taxonomies and/or too many kinds of taxonomies (“regulatory fragmentation”) in order to reduce the costs of compliance and opens up more profitable opportunities for investments.
- Manuals and publications:** Advising can also be provided in written form, such as a manual on how to develop a taxonomy (e.g. by the World Bank¹). Different public, international (e.g. OECD), private and non-profit organisations are monitoring the development of taxonomies around the world and publishing overviews of what taxonomies are being developed and by whom. These overviews can be used as inputs for discussions at the start of the taxonomy process and guide choices on what kind of taxonomy to develop at the national level, as well as its scope and coverage.



REMINDER

As explained in Module 1, external influences might result in a taxonomy being drafted based on the taxonomies of other countries, regions or organisations, either with or without country-specific adaptations.

On the other hand, some FFA countries are starting from scratch based on discussions with national participants and include country-specific objectives with country targets and instruments.

External influencing processes may also affect the choices of the taxonomy drafters. When donor driven, there might be some pressure to take the interests of international investors into account, for instance, by designing a taxonomy that is close to the standards of the donor country and its financial industry.

Some FFA countries that began developing a taxonomy in 2021 with the involvement of different foreign donors are seeing a wide variety of draft taxonomies proposed (see Module 4 for an overview of taxonomies in FFA countries).

¹ World Bank. (July 2020). Developing a National Green Taxonomy: A World Bank Guide. Available at: <https://documents.worldbank.org/en/publication/documents-reports/documentdetail/953011593410423487/developing-a-national-green-taxonomy-a-world-bank-guide>

3. WHO IS CONSULTED AND CAN COMMENT ON THE DRAFT TAXONOMY?

During the initial drafting of the taxonomy there may have been consultations, advisors or various stakeholders involved, but these could have been quite informal or behind closed doors.

When a first draft is written and published, official, public and informal consultations can be held to comment on the first draft.

Official consultation processes:

There are different formats in which official or public consultations can take place, including:

- An online public consultation announced on the website of the initiating body that is held during a specified period. Feedback can be provided in the form of a questionnaire. The online consultation or questionnaire can target particular stakeholders, asking general questions addressed to the public/citizens, and specific questions for experts and those directly affected by the taxonomy.
- Meetings (online) during which one or various groups of stakeholders can provide verbal input and explain their positions.

Informal consultations and lobbying:

In addition to the official consultations, various stakeholders will try to influence the taxonomy to their benefit such as:

- Lobby associations and lobbyists from the financial and mainstream economic sectors, who will lobby and influence through meetings and letters. This happens especially if the draft taxonomy is considered too detailed with strict screening criteria, too far from market practices or intends to be made compulsory.
- Meetings and letters from CSOs providing input or protests to improve the taxonomy so that it defines activities, projects or companies that significantly contribute to the Paris climate goals, SDGs and sustainability impacts.

IMPORTANT CHARACTERISTICS OF THE CONSULTATIONS

- **It is important that a public consultation** is held to ensure the drafting of the taxonomy is not taken over by a small group of people or vested interests.
- **The announcement** of an (online) consultation needs to be widely distributed and made widely accessible, so that a broad group of interested stakeholders, experts and academics, CSOs and citizens can respond.
- **The period of the consultation** has to be long enough to ensure that stakeholders and experts

who have little capacity and resources to respond to public consultations, but who have knowledge of on-the-ground impacts, can participate.

- **CSOs can raise awareness** and a sense of urgency about the consultation and facilitate inputs from civil society. For instance, before responding, NGOs and CSOs can first consult with affected people (e.g. youth, vulnerable communities) who do not have the means to provide input to official consultations. This can prevent the public interest from being sidelined and country-specific challenges from not being prioritized. CSOs can also draft sample responses to the consultation that other CSOs or citizens can use to prepare their own (online, written) response.

INTEGRATING THE RESPONSES TO THE CONSULTATION

Responses to a consultation on a draft taxonomy are not automatically integrated in the next draft of the taxonomy. How the written, oral, formal and informal consultation responses and lobbying are processed and integrated in the taxonomy drafting process will determine which groups have the most influence and impact. Therefore, it is important that:

- Sufficient human, financial and technological resources are allocated to integrating and discussing all the responses and inputs.
- Inputs from different types of stakeholders are given equal weight and the public interest (sustainability objectives) is given priority. This means that even if one group of stakeholders provides the most input, its inputs and interests are balanced with those of other stakeholders and, importantly, with the public interest. The financial sector typically has the means and the strategy to provide many more inputs, and in different ways, so that its interests might become more integrated in the taxonomy than the long-term interests of the younger generation whose future will be affected (e.g. by climate change).
- Responses to (online) consultations are made public, apart from some exceptional cases (e.g. whistleblowers).
- A summary of the consultations is published and the body responsible for (coordinating) the subsequent drafting process comments on how it integrated the responses.

4. WHO MAKES THE FINAL DECISION?

Once all the consultations and redrafting of the taxonomy text have been finalized (through the various decision-making and influencing processes described earlier), a final decision has to be made. Who makes the final decision ultimately influences the content, the credibility and the use of the taxonomy.

The final decision is not necessarily taken by the same persons or body who initiated or drafted the taxonomy. The final decision-makers can be the following:

- **The central bank or other financial authority:** If the central bank or other financial authority makes the final decision and taxonomy becomes a regulation, they have a mandate to supervise the implementation. The financial authority supervising the investors' market (e.g. Securities Exchange Commission) might be the one in charge since taxonomies have, so far, primarily targeted the decision-making of investors and the green bond market.
- **The government:** The Ministry of Finance or group of ministries responsible for the taxonomy sectors, sometimes together with financial authorities, can decide on the final text of a taxonomy. The taxonomy could then be used not only by private investors, but also in other areas, including for policymaking and subsidies by ministers of different sectors.
- **Parliament:** The final taxonomy text can be decided by parliament and enshrined in law, i.e. become a legally recognized definition and standard to be enforced by supervisors. This also means that amendments to the final draft text will be made during parliamentary deliberations, which will be influenced by various groups and processes.
- **Multi-stakeholder forum:** The multi-stakeholder group that initiated the taxonomy might make the final decision. This would make the taxonomy a voluntary standard. How the taxonomy will be applied, monitored and enforced might not always be clear if it is not submitted to official decision-makers mentioned above. It would be expected that financial and corporate stakeholders would intend to apply the taxonomy as a voluntary standard.
- **Financial sector association:** A national private banking or investment association can decide on a taxonomy that becomes an industry-led, private sector voluntary standard that members can apply (e.g. the Cambodian Sustainable Finance Principles Implementation Guidelines by the Association of Banks in Cambodia, 2019²). Financial authorities can decide to make a private standard an official standard, with or without modifications.

WHY THE FINAL DECISION-MAKING PROCESS IS IMPORTANT

- When a taxonomy regulation or law is decided upon and issued by a financial authority or parliament, it has credibility as an official standard. The publication of the official standard or the law makes it a publicly available reference. Whether or not there is an obligation to use the taxonomy might be part of the regulation or law, or it might be included in a different regulation or law (see Module 3 on the use of a taxonomy).
- The final decision-making processes can see aggressive formal and informal influencing processes through meetings, letter writing, proposed text for amendments, street protests and other lobby and advocacy methods. This can pitch the interests of the financial sector, the government, particular civil society groups and the long-term public common good against each other, as no group wants the application of the taxonomy to harm its own interests. Examples are opposing detailed screening criteria to avoid the costs of verification or, in the EU, the inclusion of gas and/or nuclear energy in a taxonomy that aims to eliminate fossil fuels and environmental damage. The group with the most lobbying power might be able to get its interests prioritised.
- When a taxonomy is decided upon by a multi-stakeholder group, the final decision might be a compromise among stakeholders with very different interests or it could be designed in the interest of the strongest stakeholder.
- The details of the taxonomy can be decided during different stages, for instance, as with the EU and ASEAN taxonomies. First the objectives, principles, screening criteria, minimum guarantees and exclusion clauses of the taxonomy are defined in a general way. Detailed descriptions of requirements and how to apply them to particular activities, projects and companies in particular sub-sectors might be decided later by one of the decision-making bodies described above. These decisions are also very important as they determine how a taxonomy is concretely applied.

² The Association of Banks in Cambodia and Cambodian Sustainable Finance. (1 February 2019). Cambodian Sustainable Finance Principles Implementation Guidelines. Available at: <https://www.ifc.org/wps/wcm/connect/8ce9ddc0-2422-4e69-aa8b-e4f3c8cc3eec/Cambodia+SF+Principles+-+Implementation+Guidelines.pdf?MOD=AJPERES&CVID=mGdMKuz>

5. FUTURE REVIEWS

The taxonomy can include a review clause that determines when a revision of the taxonomy is due. This would mean that the taxonomy should be flexible to accommodate changes in the future. Those involved in the review process and those deciding on the revised taxonomy are likely to be the same as those mentioned in the previous section.

The same formal and informal processes may apply when reviewing, expanding and improving an existing taxonomy. Those drafting and making decisions about the revised or expanded taxonomy can be subject to the following requirements of the review clause:

- The review process must take place by a specific date after the taxonomy has been in operation for a certain period.
 - The purpose of the review process is clarified, for example, to adapt the definitions to new technologies or new standards or criteria to achieve the objectives more effectively and quickly (e.g. to prevent global warming from accelerating).
 - The review process needs to consider or decide on additional objectives or sectors to be covered by the taxonomy. For example, whether a green taxonomy needs to be complemented by a sustainability taxonomy; identifying and describing activities, projects or companies that prevent the objectives from being achieved; or introducing a taxonomy with a new objective, such as a social taxonomy.
- The review process must be preceded by an evaluation and public report that assesses how, and how much, the existing taxonomy has been applied, whether the objectives are being achieved, whether there is a need for better or new objectives and/or definitions and whether the needs of different stakeholders have been sufficiently met.



REMINDER

The review process will need to determine how financial products based on the original taxonomy will be treated. Will they be allowed to exist alongside those based on the new taxonomy (“grandfathered”) or will they need to be changed and adopt the new definitions (see Module 1 on taxonomy content)? That decision can be made once an evaluation of the application of the taxonomy has been completed and integrated in the revised taxonomy.

REVIEW QUESTIONS

REVIEW QUESTIONS

- Who can begin drafting a taxonomy?
- Who can be involved in drafting a taxonomy?
- How can civil society (organizations) be involved in drafting a taxonomy?
- Why is it important who makes the final decision about the taxonomy text?
- How can a taxonomy be changed?





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