



FAIR FINANCE ASIA

MODULE 3

**THE USE, APPLICATION AND
IMPACT OF A TAXONOMY**



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.

About SOMO (Stichting Onderzoek Multinationale Ondernemingen - Centre for Research on Multinational Corporations)

SOMO is a critical, independent, not-for-profit knowledge and research centre on multinationals. Since 1973 SOMO has investigated multinational corporations and the impact of their activities on people and the environment. SOMO provides custom-made services (research, consulting and training) to non-profit organisations and the public sector. It strengthens collaboration between civil society organisations through its worldwide network. More information on SOMO can be found at <https://www.somo.nl/>

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If a taxonomy is developed as a tool for a sustainable finance policy, decisions will need to be made about its content (see Module 1) and who will be involved in the decision-making process (see Module 2). A third important aspect is how the taxonomy will be used. The way a taxonomy is to be implemented can be included in the draft text, proposal, regulation, law or voluntary standard of the taxonomy. However, since a taxonomy is, in principle, simply a classification of definitions based on particular objectives and criteria, it can be used in different ways, including in supplementary proposals, tools, regulations, laws, standards or policies. This is explained in the following sections.

Once it has been decided how to implement a taxonomy, there are still various challenges and obstacles to be overcome.

How a taxonomy is intended to be applied and used, and how it is actually implemented, will be crucial to how effective it is at orienting finance towards the objectives and aligned activities, projects and companies.



1. APPLICATION AND USE OF A TAXONOMY

There are various ways a taxonomy can, or must, be applied and who has to apply it. A taxonomy can be an (officially) recognized standard introduced as a regulation by financial authorities; as policy guidelines by the government; as a law by the parliament; or guidance by and for the financial industry.

How a taxonomy is to be applied, in a mandatory or voluntary way, and by whom, can be in the same regulation, policy guidelines, law or guidance, or it can also be in a separate regulation(s), guideline(s) or law(s).

VOLUNTARY APPLICATION

A taxonomy can be applied voluntarily, in other words, no one is required to apply it. The taxonomy can be considered an officially recognised standard and guidance, but is only applied by those who want to effectively or visibly achieve the objectives of the taxonomy. For example:

- It can be applied as guidance for the financial sector when making decisions on loans or investments or, as Malaysia's taxonomy states, to facilitate "robust and consistent assessments of economic activities and their impact on climate and the environment".¹
- Financial products that are voluntarily aligned with the taxonomy will choose companies and projects that voluntarily align their activities or operations with the taxonomy. The shares of such companies can be included in investment funds that claim to be aligned with the taxonomy, or loans for such projects can be provided by banks willing to contribute to the taxonomy's objectives. However, these financial products will exist alongside other financial products or loans that also claim to apply climate, environmental or social criteria that differ from the taxonomy.
- When a taxonomy is introduced by the financial industry, it can be voluntary as the financial sector may find it difficult to enforce.
- Governments can voluntarily use the taxonomy to decide whether or not to provide subsidies, (export) guarantees or other support, to activities, projects or companies that are aligned with the taxonomy and with policies that have the same objectives.
- The ASEAN regional taxonomy is voluntary, which allows ASEAN Member States to adopt national taxonomies that are in line with the ASEAN taxonomy or that diverge from it. So far, it appears

that national taxonomies are taking precedence over the regional ASEAN taxonomy.

COMPULSORY APPLICATION

When the application of a taxonomy is compulsory, this can be for different uses and users, including:

- Banks and/or investors need to finance a minimum number of activities, projects or companies that are aligned with the taxonomy.
- Investment funds or other investment products that claim to be contributing to climate, environmental or social objectives can only finance activities, projects or companies that are aligned with the taxonomy. All other green, social or sustainability investment funds or products would be banned and their use sanctioned. A softer obligation would be a green investment fund that must have at least 90 per cent (or another percentage) of shares in companies, or bonds of activities and projects, that are aligned with the taxonomy.
- A company, bank or government that issues a green, social or sustainability bond are compelled to finance activities, projects or companies aligned with the related taxonomy.
- Governments and ministries that have policies with the same objectives as the taxonomy and want to provide subsidies or other financial support can only finance activities, projects or companies aligned with the taxonomy.

¹ Bank Negara Malaysia. (30 April 2021). Climate Change and Principle-based Taxonomy. Available at: <https://www.bnm.gov.my/documents/20124/938039/Climate+Change+and+Principle-based+Taxonomy.pdf>.

MIXED APPLICATION

The application of a taxonomy can be both voluntary and compulsory. For example, in the EU, the climate and environment taxonomy must be used by governments that issue green bonds, but it does not have to be applied by commercial green bond issuers. The latter can use their own criteria and cannot claim to be in accordance with the EU taxonomy standard. In addition, large EU investors, banks and companies must report the proportion of their financing or investments that are aligned with the taxonomy, while smaller companies, banks and investors can do so voluntarily.

REPORTING AND DISCLOSURE

The taxonomy can be used as a standard for voluntary or compulsory reporting by designated companies, financial sub-sectors (e.g. only by institutional investors or by banks) or authorities providing financial support.

- When compulsory, each of the financiers must disclose the percentage of their financing devoted to activities, projects or companies that are aligned with the taxonomy. Such reporting can indicate the extent of sustainability impacts as defined by the taxonomy's objectives.
- Reporting in detail would disclose which categories of the taxonomy are being financed, as well as allow classification of loans or investments.
- An investment fund consisting of shares and/or bonds from various companies or projects, may either voluntarily or be obliged to disclose what percentage of the investments is aligned with the taxonomy.

LABELLING OF FINANCIAL PRODUCTS

The taxonomy can be used for labelling bonds, investment funds or other investment products, shares of companies or other activities and projects that are being financed. Labelling of financial products can be a certification that the financed activities are aligned with the taxonomy. Labelling can also use different colours to indicate the degree to which the financial product is aligned with the taxonomy, as with the draft ASEAN taxonomy.

MONITORING

Public agencies or private bodies can generate (public) statistics of all reported financing that is aligned or labelled in line with the taxonomy. Especially when reporting is compulsory, the statistics will disclose how much financing in a country, sector and/or government is allocated to meeting the objectives of the taxonomy. This would allow progress to be monitored by authorities, the financial sector itself, researchers and civil society to determine the extent to which the taxonomy is orienting financing in alignment with the taxonomy and is having an impact according to the objectives.

PROHIBITION

Prohibition or discouragement of financing based on a taxonomy that defines activities, projects or companies that are harmful to, undermine or have negative impacts on the stated objectives (i.e. a climate or environmentally harmful, dirty or brown taxonomy) can be done in various ways, including:

- What is covered by a harmful taxonomy can be prohibited from being financed, either by law or by the regulator.
- A harmful taxonomy can identify what needs to be phased out by a certain deadline (transition taxonomy).
- If financing based on a harmful taxonomy is not forbidden, the taxonomy should identify what is being discouraged from being financed and should be phased out.
- Banks or investors that finance activities, projects or companies that are aligned with a harmful taxonomy can be required by regulators and supervisors to set aside more capital in reserve in case loans are not repaid or their value drops (e.g. stranded assets due to climate change impacts). In other words, supervisors, regulators and legislators can specify that potential financial losses are a risk to financial instability, either by one or a range of banks and/or investors that finance harmful activities, projects or companies (see section 2 of this module). Since setting aside more capital is costly for financiers, it will discourage them from financing.
- A harmful taxonomy can indicate what activities or projects cannot be operated by a company in parallel with financed activities or projects that align with a taxonomy with positive climate, environmental, social or sustainability objectives. For example, a green bond that finances the development of a renewable energy project by an oil company should not be called a green bond if that company is also drilling new oil wells.

RISK ASSESSMENT

For a bank to know how many potential low- or non-performing loans they have or for an investor to know how many potentially devalued investments they have, a taxonomy can be used by the bank, investor or financial supervisor to assess the risks of stranded assets. Using a taxonomy with positive objectives can also identify how many assets are not aligned with the taxonomy and at risk of financial loss.

A risk assessment provides information to supervisors on whether they need to act against the risks to financial instability, for example, by requiring additional capital reserves for potential losses or forbidding them to continue to finance risky activities, projects or companies that are not aligned with a taxonomy.

Also, credit rating agencies (CRAs) can use taxonomy-aligned reporting or their own taxonomy-based assessments to identify potential or future financial losses, which are reflected in their ratings of the creditworthiness of banks, investors or companies.

APPLICATION BY DOMESTIC OR FOREIGN FINANCIERS

When a taxonomy is introduced in a country, it can be applied only by domestic financiers or by any bank or investor that operates in the country, including foreign ones. When the application of a taxonomy is made compulsory in order to claim that a loan or investment is having a positive climate, environmental, social or sustainable impact, then both domestic and foreign financiers must implement all the taxonomy criteria.



HOW TO EVALUATE THE EFFECTIVENESS OF A TAXONOMY?

A taxonomy that has positive impact objectives can be effective in orienting more capital to aligned activities:

- **When a taxonomy is made compulsory** for loans and investments that claim to contribute to its objectives, more activities, projects and companies are financed. When it is compulsory for any loan or investment, all existing financing must be oriented to the objectives – an obligation that does not yet exist.
- **When the use of a taxonomy is voluntary**, there is no guarantee that it will be applied sufficiently for orienting finance and have an impact that achieves the objectives of the taxonomy. The financial sector tends to avoid the costs of applying a taxonomy that is too complex or descriptive or when taxonomies in various countries are too divergent. When left voluntary, it can be confusing for individual investors, customers or citizens to know which claims about positive sustainability impacts can be trusted.

2. PRACTICAL ISSUES AND CHALLENGES OF APPLYING A TAXONOMY

The capacity to apply a taxonomy and verify its application requires attention from all stakeholders, since there are many practical issues and challenges involved. These include:

DATA AVAILABILITY

Obtaining accurate information on whether an activity, project or company aligns with the objectives, principles, screening criteria, minimum safeguards and other requirements of a taxonomy can be difficult for those who want to finance or create a financial product that aligns with the taxonomy (e.g. a green bond that finances activities aligned with the taxonomy).

There might be a lack of qualitative and quantifiable information available from companies, projects or authorities on whether their activities adhere to all the taxonomy's requirements. This has resulted in sustainable finance policies that promote and regulate more detailed corporate reporting on sustainability metrics (e.g. amount of CO2 emissions, women in top management).

VERIFICATION

To guarantee that a taxonomy is being applied and financed properly, financiers will want or need verification to avoid misleading claims and incorrect reporting. This is often done by hiring the services of an independent, third-party commercial (ESG) data, rating, and verification company (e.g. Sustainalytics, MSCI ESG Rating²).

However, since these companies are not typically regulated, there is currently no guarantee that taxonomies are being applied correctly. Regulating these ESG-rating companies might become part of sustainable finance policies in coming years. There are also no accounting regulations or laws that set standards for accountants to ensure that reports on sustainability metrics, taxonomy-aligned activities, projects, companies, loans or investment (products) are correct. However, the development such international accounting has begun.³

SUPERVISION AND ENFORCEMENT

How to supervise those claiming to use the taxonomy for their investments or lending is often not operationalised. It is not expected that financial supervisors can verify on the spot whether the activities, projects or companies that are being financed by banks or investors are fully applying the requirements of a taxonomy. So far, few provisions have been introduced on what sanctions or other measures will follow if, at the end of an investment or loan period, the result is not what the taxonomy requires. When financial supervisory authorities can detect that particular taxonomy requirements are clearly not being fulfilled or information is not correct, they can use their mandate to sanction the mis-selling of investment products (i.e. based on misleading information to financial markets).

A taxonomy regulation, law or voluntary standard can also specify what actions need to be taken when the objectives of the taxonomy are not achieved. This all means that supervisors must have the necessary human and financial resources and expertise to implement new and existing supervisory mandates. Other supervisors, such as labor law inspectors, might need to be involved to verify and enforce claims of taxonomy alignment.

COSTS AND CAPACITY

The identification, documentation, reporting and verification of activities that fulfil the requirements of the taxonomy make the financing of taxonomy-aligned activities with positive objectives costlier than mainstream, often unsustainable, activities. For example, the marketing and information/disclosure requirements of investment products that are taxonomy aligned require new and special capacity for staff to explain and sell them.

Bank staff will need expertise to engage and advise companies that apply for a loan on how to adhere to a taxonomy's requirements. This means that investors and banks need to train staff to construct, issue and sell, or lend to, taxonomy-aligned activities, projects or companies, all of which is expensive.

² For more information, see for instance: <https://theimpactinvestor.com/esg-rating-agencies/>

³ See the International Financial Reporting Standards (IFRS) Foundation: <https://www.ifrs.org>

Easy-to-use tools and manuals on how to apply the taxonomy can be helpful to increase usage and reduce costs for financiers. Training and manuals are being developed and coordinated by the financial sector, consultants, financial authorities, academics and civil society. Government incentives, subsidies and tax advantages for those implementing the taxonomy might alleviate some of the extra costs.

ONE OF MANY TOOLS, STANDARDS, REGULATIONS AND POLICIES:

A taxonomy can be just one of many tools that finance or align activities, projects and companies with sustainability objectives, and require reporting and enforcement. For instance, there might be regulated norms for what a green or social bond can finance (e.g. in Indonesia) or corporate responsibility reporting obligations, such as the Indian Business Responsibility and Sustainability Reporting Standard (BRSR).

The UN Guiding Principles of Business and Human Rights (UNGPs) have often been used by companies, and companies are increasingly being rated according to their environmental, social and governance (ESG) risks and impacts based on various definitions of ESG, the ASEAN Green Bond Standards and others.

The taxonomy can include some of these norms in its requirements and criteria, for example, any activity, project or company financed under a social taxonomy needs to respect all core International Labor Organisation (ILO) labour rights. The other standards can also use the taxonomy to clarify and harmonise definitions, for instance, to prescribe what “E” of ESG entails. These various tools often overwhelm the financial sector and companies that have traditionally prioritized profitability over sustainability.



CONCLUDING REMARKS

Use vs. usefulness.

The complexity of prescriptive taxonomies and the related costs of development, verification, monitoring and disclosure might result in the taxonomy not being used by lenders and investors. However, strictly defined and verified activities and financing might be more useful and effective in contributing positively to the objectives of the taxonomy. This might especially be the case if, for example, the selected economic (sub-) sectors and activities described by the taxonomy prioritize sectors where investments in positive effects are needed most, for instance, in energy or agriculture (e.g. as in the ASEAN draft taxonomy).

In the long term, the value of taxonomy-linked assets might become more valuable and offset the additional costs.

However, the challenge of covering the extra short-term costs are often absent from discussions. Also, there is still a question of whether taxonomy-aligned investments will be more or less profitable, as all externalities will ultimately have to be included, for example, living wages throughout the value chains of projects and companies and extra measures to protect biodiversity and prevent pollution. There is still a trillion-dollar gap in financing climate mitigation, climate adaptation, environmental resilience, the closing of the inequality gap and the achievement of the SDGs.

The use of less complex, non-descriptive and principles-based taxonomies is easier and less expensive and might attract more financing.

However, they are likely to be less effective in achieving the taxonomies' objectives and verification might be more flexible. Such taxonomies can more easily hide misleading claims and greenwashing.

Trillions of dollars are still financing climate change and environmentally and socially harmful activities that might undermine the effectiveness of funding taxonomy-aligned activities with positive impacts.

Using taxonomies based on principles, such as do no significant harm and minimum social or environmental safeguards, might reduce financing that undermines the usefulness of taxonomy-oriented financing. Using a taxonomy that identifies which activities, projects and companies are harmful and should be phased out or prohibited is another way of improving the effectiveness of a positive-impact taxonomy.

REVIEW QUESTIONS

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- Who is interested in using a taxonomy?
- Does developing a taxonomy automatically result in it being used?
- What can a taxonomy be used for? What do you want a taxonomy to be used for?
- Is it confusing to introduce a taxonomy when there are other instruments that promote sustainable and responsible corporate behavior? Can these different tools be integrated or coordinated?
- What are the obstacles to using a taxonomy? How can they be overcome?
- When should a taxonomy not be used?
- How can one evaluate whether a taxonomy is effective and being used effectively?





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