



FAIR FINANCE ASIA

MODULE 1

**WHAT IS A TAXONOMY FOR A
SUSTAINABLE FINANCE POLICY?**



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.

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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)

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INTRODUCTION

Although a universal definition of taxonomy has not yet emerged, some common characteristics are being promoted by the ASEAN, the G20 and the European Union (EU)-China.¹ Some FFA countries have developed their own taxonomy, ranging from those focused on climate change to broader sustainable development objectives (see Module 4 for an overview of taxonomies in FFA countries).

This first module explains what a taxonomy is – and what it is not – as well as the content, coverage, and distinguishing features of different kinds of taxonomies. Module 2 and Module 3 explain two important and related aspects: how the text of a taxonomy is being developed and decided upon, and how a taxonomy can be used.

This module begins by identifying the basic elements included in the text of a taxonomy. There have been many initiatives to develop and issue taxonomies on sustainable finance, and this module might not capture all the varieties. However, the characteristics covered in this module are important elements of a useful and effective taxonomy and should help to assess whether a taxonomy is sufficiently robust to guard against misleading claims.

WHAT THE TERM “TAXONOMY” MEANS (AND WHAT IT DOES NOT MEAN)

The term “taxonomy” does not come from the financial world, but rather the scientific world. A taxonomy is a classification and categorization system for describing and defining organisms.

As a sustainable finance tool, a taxonomy is a classification and categorization system that describes and defines activities, companies or projects that can be financed to meet one or more sustainable finance objective. A taxonomy often includes broadly outlined principles and criteria that must be fulfilled by the activities, companies or projects financed according to the taxonomy.

The text of a taxonomy can include a list of definitions of activities, projects or companies that fulfill these principles and criteria.

A taxonomy, in principle, is **NOT**:

- An obligation to use the taxonomy (see Module 2).
- A sustainable finance policy nor a sustainable development or social policy. A taxonomy is a tool to clarify a sustainable finance policy and orient finance by banks and investors to, for instance, meet climate change commitments, prevent environmental degradation or achieve the SDGs.
- A financing plan. A taxonomy does not specify the extent to which loans or investments should be aligned with the taxonomy.

REMARKS

- A taxonomy can also include categories of activities, companies or projects that are not part of the taxonomy.
- Descriptions and definitions of what is to be considered climate change mitigation or adaptation, environmentally (“green”), socially or sustainably positive can also be part of other sustainable finance tools, such as descriptions and regulations of green bonds, social bonds or sustainable bonds (investment instruments). In turn, a climate, green, social or sustainable bond can be based on a taxonomy.
- The term taxonomy can be confusing if it is combined with how it is to be used and by whom, for instance, a taxonomy regulation or law.



IS “TAXONOMY” THE SAME AS “ESG”?

To date, no taxonomies for sustainable finance have classified or defined activities that are fully aligned with environmental, social or governance (ESG) factors. In other words, ESG has not yet been clearly defined, nor have activities that claim to meet ESG criteria been clearly classified and harmonised. However, there might be an overlap when a taxonomy defines activities, projects or companies with positive environmental and/or social impacts and those definitions are used to define “E” and/or “S”.

¹ For information on the ASEAN taxonomy, see Module 4. To learn about the EU-China common ground for a taxonomy, see: International Platform on Sustainable Finance. (November 2021). Common Ground Taxonomy – Climate Change Mitigation – Instruction Report. Available at: https://ec.europa.eu/info/files/international-platform-sustainable-finance-common-ground-taxonomy-report-2021_en.

1. OBJECTIVES OF A TAXONOMY

The text of a taxonomy states the objectives of the taxonomy. These objectives clarify what is being classified, categorised and defined. The objectives delineate the categories and related activities, sectors, projects and companies covered by a taxonomy, as well as their expected impacts when they are financed.

These objectives can be general or they can be described in specific terms, as follows:

The **general objectives** of a taxonomy can be to:

- Align with the Paris Climate Agreement and/or transition to it;
- Contribute to the protection, resilience and restoration of the environment;
- Achieve the SDGs;
- Contribute to and improve the application of social standards and rights, such as human rights and labour standards;
- Achieve sustainable development through global climate change mitigation and meet high environmental and social standards; or
- Define activities that harm the climate, environment, human rights and sustainable development or other objectives in the taxonomy.

Specific objectives or categories can relate to:

- **Climate change goals:** climate change mitigation and adaptation or contributing to a national or regional governmental programme to achieve the Paris commitments (nationally determined contributions, or NDCs).
- **Environmental impact:** halting biodiversity loss; contributing to biodiversity; solving water and land degradation problems; reforestation and strengthening forest resilience; or contributing to a circular economy.

- **Social changes:** promoting the inclusion of marginalized groups; strengthening respect for labour rights and human rights; promoting women's rights; contributing to access to basic needs (food, water, housing, health and education) and adequate living standards; or contributing to a national or regional programme to achieve human rights and social standards.
- **Transitioning away from harmful operations:** reducing GHG emissions; transitioning to a fossil fuel-free energy and economy; transitional activities; phasing out fossil fuel-based production that contributes to climate change; or avoiding and preventing specific climate, environmental or social problems at the national or regional level.
- **Comprehensive sustainable development:** ensuring a positive contribution to and impact on climate, the environment, social standards, human rights and good governance; contributing to all aspects of the SDGs.

REMARKS

- Clarification of the objectives of the activities, projects or companies that claim to be aligned with a taxonomy is critical. It will be the overarching factor that determines the other elements of the taxonomy (principles, criteria and sectors and activities covered).
- The more detailed the objectives, the easier it will be to develop a taxonomy that defines activities, projects or companies with a concrete positive impact and add value to achieve the objectives.



BE AWARE OF POLICY OBJECTIVES

From a policy perspective, the overall objective of a taxonomy for sustainable finance is to orient finance to achieve the stated objectives. The indirect objective of a taxonomy is to avoid misleading claims about what is being financed and its positive impacts on the climate, the environment, social issues or sustainability, often referred to as “greenwashing”.

The taxonomy should instil trust, enhance understanding and allow comparability of what is being financed and for what impact. These objectives are not part of a taxonomy's definitions, but could be mentioned in the introduction or preamble.

2. TYPES OF TAXONOMIES

There are different classes of taxonomies depending on whether the objectives are general or more specific.

- A **climate taxonomy** covers climate change mitigation, climate change adaptation and full alignment with the Paris climate goals.
- A **green taxonomy** covers both climate and environmental objectives.
- A **blue taxonomy** covers improvements to water, river and sea or ocean-related problems.
- A **transition taxonomy** covers activities, projects, processes and companies that allow, enable, or are in the process of, transitioning to fossil fuel-free energy or a Paris climate-aligned economy.
- A **climate-harmful taxonomy**² identifies what contributes to climate change (also referred to as a “brown” taxonomy, “polluting” or “dirty” taxonomy) and what is not aligned with the Paris climate goals.
- A **social taxonomy** can cover all aspects of improving or achieving social standards and human rights.
- A **socially harmful taxonomy** identifies breaches of human rights and social standards.
- A **gender taxonomy** covers women and gender-related aspects, for instance, contributing to women’s empowerment, achieving women’s rights, avoiding discrimination and promoting equal opportunities for women.
- A **sustainable taxonomy** is a comprehensive, more holistic taxonomy that covers climate, environmental and social standards, human rights objectives and improvements, all the SDGs and/or all ESG impacts.

REMARKS

- The terms “green taxonomy”, “sustainable taxonomy”, “climate taxonomy” or just “taxonomy” are often used interchangeably, but this does not clarify the objectives and categories of a particular taxonomy. Most of the taxonomies that have been developed (or are in development) by a financial or governmental authority or the financial industry are climate taxonomies, green or environmental taxonomies, and, to a lesser extent, social or sustainable taxonomies.
- There are discussions, for example in the EU, about whether activities that have no impact or no significant impact on climate change or the environment should be included in a “no significant environmental impact” taxonomy. Such activities or companies are considered to have no or little climate impact due to their nature or size, for instance, service sectors such as online advisory services. However, defining what it means to have no (significant) impact on climate change, the environment and/or social standards might not be easy and could change over time.³



WHAT TO MONITOR?

There is not yet a taxonomy that identifies harmful activities that should no longer be financed. In most countries, there is huge resistance from the corporate sector and government authorities to a harmful taxonomy that identifies fossil fuels that cannot transition to zero emissions and need to be eliminated. The reason they give is that the economy still relies on energy from fossil fuels, which are still profitable and need to continue to be financed to prevent disruption to the economy and socio-economic development from a transition or divestment from fossil fuel activities, projects and companies. Once identified, withdrawing financing from such harmful activities would be easier and could be done swiftly by the financial sector or through regulations.

Civil society has been pressing for a taxonomy that identifies coal, fossil fuels and other climate-harmful emissions as a tool to halt financing of rapidly evolving climate change. There is now a growing trend in creating taxonomies that clearly identify what transition processes can be financed.

² For the pros and cons of a climate- and environmentally harmful taxonomy, see: Platform on Sustainable Finance. (12 July 2021). Public Consultation: Report on Taxonomy Extension Options linked to Environmental Objectives, p. 10. Available at: https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/sustainable-finance-platform-report-taxonomy-extension-july2021_en.pdf.

³ For the pros and cons of a “no significant environmental impact” taxonomy, see: Platform on Sustainable Finance. (12 July 2021). Public Consultation: Report on Taxonomy Extension Options linked to Environmental Objectives, p. 11. Available at: https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/sustainable-finance-platform-report-taxonomy-extension-july2021_en.pdf.

3. WHAT DOES A TAXONOMY COVER?

Ultimately, a taxonomy is a guide for financing concrete activities, projects and/or companies. How the stated objectives of a taxonomy are achieved through financing depends on what activities, projects and/or companies the taxonomy covers and classifies. Especially important is whether these activities, projects and/or companies are defined or described based on a taxonomy's detailed or general requirements, principles, technical criteria and objectives.

3.1 ACTIVITIES, PROJECTS AND COMPANIES

A taxonomy guides, classifies and/or defines what can be financed. This will include one or more of the following:

Activities: A taxonomy primarily defines the economic activities of companies or authorities and not, for instance, energy savings by consumers. These activities can be easily identified using codes or numbers that are already used for the classification of economic activities in official statistics, customs documents, etc. An example of an economic activity that contributes directly to the objective of climate mitigation is electricity generation from wind power, which is a separate activity from installing windmills.

Projects: A taxonomy can define projects operated by companies or authorities that achieve the stated objectives over time. An example of a project that contributes to the objective of climate mitigation is the construction of a windmill park that results in operating an electricity generator from wind power.

Companies: The objectives of a taxonomy can be achieved by a company as a whole or by its activities, but these can be difficult to distinguish.

For example, a company can contribute to the objective of climate mitigation by reducing its CO₂ emissions or by reducing waste as a recycling company. An example of contributing to a social objective is the implementation of a no-discrimination policy in all phases of production or services in which a company is involved.

REMARKS

Many taxonomies only define economic activities and not projects or companies. However, for companies that want to use the taxonomy to attract financing it is not always easy to delineate an activity as part of their operations.



WHY IS THE DIFFERENCE BETWEEN AN ACTIVITY AND A COMPANY IMPORTANT?

A company that operates an economic activity covered by a taxonomy can, at the same time, operate activities not covered by the taxonomy. In this case, the positive results of a taxonomy-aligned activity can be undermined by the company's other activities. An example is an oil company that receives finance to invest in renewable energy production while continuing to drill new oil wells that will increase CO₂ emissions.

3.2 ECONOMIC SECTORS COVERED

A taxonomy can classify activities, projects or companies by one, several or all sub-sectors of an economy's agricultural, industrial and services sectors. Examples of sub-sectors of the economy that can be included in a taxonomy are:

- Horticulture
- Fisheries
- Forestry activities
- Transport sectors
- Energy sourcing and power generation
- Mining
- Construction
- Manufacturing
- Consumer goods
- Information and communication (technology)
- Financial services sector (banking, investment industry, private pensions)
- Health services

When one or more sub-sectors are classified under the taxonomy, the related activities, projects or companies can be described in terms of how they:

- **Already meet the objective of the taxonomy.**
Examples of alignment with the Paris climate goals are production and services with no GHG emissions, such as rail transport that uses wind power, or afforestation (planting trees to create a new forest). An example of alignment with social objectives is the provision of affordable and accessible health services.

- **Contribute to the objectives of the taxonomy by transitioning to them.**

Examples include manufacturing, electricity generation or horticulture production that have much lower CO₂ emissions (below a described threshold) than traditional manufacturing, electricity generation or horticultural practices (now often in glass houses).

- **Are harmful and counterproductive to the objectives of the taxonomy** and should be excluded or identified to be phased out. Examples are the exclusion of coal mining and coal power plants from a climate taxonomy or exclusion of the weapons or tobacco industry from a social taxonomy.



CONTROVERSIES

- There are many discussions and controversies over whether and how fossil fuel sectors should be covered or excluded from climate or green taxonomies. Since the use of coal is a major contributor to carbon emissions, it has been very controversial to include “clean coal” or coal-based power generation with carbon capture techniques (which barely exist at scale). Whether gas and nuclear energy are transitional sectors is hotly debated. For instance, in the EU where the European Commission and some EU member states want to include these sub-sectors with some limits, civil society organizations (CSOs), and even some investors, do not want them included in green taxonomies because they do not want Paris alignment to be confused with transitional activities in financial products.
- There is also little consensus on what counts as transitioning activities to achieve the Paris climate goals. Some of the discussions are about how many years the transition period should be, what the trajectory and target should be and whether developing or emerging market countries can take longer to transition than richer countries that have already emitted significant amounts of greenhouse gases (GHGs).⁴

⁴ See ICGMA. (2020). Climate Transition Finance Handbook. Available at: <https://www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/climate-transition-finance-handbook/>.

3.3. A PRESCRIPTIVE OR GENERAL TAXONOMY?

Not all taxonomies describe in detail, per sub-sector, how activities, projects and companies should be aligned with a taxonomy. Details that define and prescribe which activities, companies or processes are consistent with the objectives of a taxonomy can vary considerably.

A PRESCRIPTIVE TAXONOMY

Provides a detailed definition of each activity, project or company in various economic sub-sectors (e.g. crop production in the agricultural sector or renovation of buildings in the construction services sector). Those details can be based on principles, requirements, technical criteria and a methodology that all activities, projects or companies must fulfil and comply with to achieve the objectives of the taxonomy. They can be derived from existing scientific evidence, in which case the prescriptive taxonomy is called a science-based taxonomy. The detailed requirements can relate to the practice, process and impact of the activities and projects.

Principles common in existing taxonomies include:

- “Significantly contribute” to the objective;
- “Do no significant harm” to the objective(s) of the taxonomy; and
- Minimum safeguards against unintended consequences beyond the objectives.

Technical requirements and criteria to be fulfilled per activity, project or company can be:

- **Quantitative minimum thresholds** to fulfil the principles, for example, how much a “significant contribution” to the objective should be.
- **Science-based targets, metrics or thresholds** to be met, for example, the exact maximum amount of emissions allowed by an activity to be aligned with the IPCC report on halting climate change.
- **Benchmarks of best practice and minimum standards** to be adhered to, for example, complying with existing certification; existing (CSR) standards and standards; national and international laws; national regulations, policies or commitments; official or private sector guidelines; international conventions and standards; or key performance indicators (KPIs).
- **Forward-looking targets and time periods** by which the objective must be met. This can include specifications for how to avoid risks of disruption to achieving the target.
- **Quantitative targets to complement qualitative objectives**, for example, in a social taxonomy that aims to eliminate discrimination, the minimum number of women in (higher) management and the maximum deviation or no difference in salaries between women and men.

For an example of a prescriptive activity included in the EU environmental taxonomy as listed in the category construction and real estate activities, see Annex I.

GENERAL OR “PRINCIPLES-BASED” TAXONOMY

The descriptions of what can be covered and financed are very general when they only identify general principles based on the taxonomy’s described objectives. For example, general principles such as “significantly contribute” or “do no significant harm” are not described with detailed metrics and thresholds. Some general taxonomies identify broad categories, such as ecotourism. To provide clarification, a general taxonomy can provide real-life examples, such as how to assess whether a palm oil company operates according to the taxonomy or not. A general taxonomy will require some quantitative and qualitative assessments and results to be interpreted by the company, operator of the activity or project and/or the lender or investor.

An example of a principles-based taxonomy is one launched by the central bank of Malaysia, Bank Negara Malaysia, which contains detailed descriptions of sectors and activities only in the form of examples (see Annex II).

REMARKS

- Prescriptive, detailed quantitative indicators and technical and/or science-based screening criteria provide a strong guarantee that the stated objectives are being met by an activity, project or company and align with the taxonomy. The criteria do not leave much room for interpretation in terms of how to operate, finance or report based on the taxonomy. It is often taken seriously by investors, especially those who want to have positive impacts.
- The term “principles-based” is somewhat confusing since principles can be part of a prescriptive taxonomy. Also, principles, or “guiding principles”, can also mean objectives. For example, in Malaysia’s taxonomy, “Guiding Principle 1” is climate change mitigation.

CHALLENGES

- It might be difficult and costly to find out which, and whether, financed activities, projects or companies are fully compliant with a prescriptive taxonomy. An often-heard complaint is the lack of data to assess whether the taxonomy’s specific requirements are being met, such as the amount of GHG emissions. Finding activities, projects and companies that fully comply with the prescriptive criteria might also be a problem, especially if the standards are high and there is little room to transition to the objectives.

- Under a general or principles-based taxonomy, various activities, projects or companies can operate under the same principle or category in very different ways. The extent to which they contribute to and achieve the objective might not be evident. However, more activities, projects and companies might align with a broad category of the taxonomy, or be encouraged to, if lack of data was less of a challenge.

A principles-based taxonomy could also prevent existing activities, projects or companies that cannot comply with a prescriptive taxonomy from being abruptly excluded from financing. For instance, some countries are heavily reliant on coal and oil for their energy supply and would favour a slower transition to fossil fuel-free energy.



A COMBINED PRINCIPLES-BASED TAXONOMY WITH OPTIONAL OR FOLLOW-UP DESCRIPTIVE ACTIVITIES

A taxonomy can be developed in different stages. Compliance can begin with the general objectives and principles, and the detailed descriptions per activity can be completed in later stages. One example is the ASEAN taxonomy proposed in November 2021.

Two-tiered ASEAN taxonomy proposal, November 2021⁵

The ASEAN taxonomy approach combines two main elements: a “Foundation Framework” that provides a principles-based framework for assessing activities and a “Plus Standard” that will later provide metrics and thresholds for eligible green activities and investments.

The **Foundation Framework** specifies that taxonomy-aligned activities must:

- 1) Target at least one of the four environmental objectives:
 - 1) Climate change mitigation;
 - 2) Climate change adaptation;
 - 3) Protection of healthy ecosystems and diversity; and
 - 4) Promotion of resource resilience and transition to a circular economy.
- 2) Adhere to two essential principles or criteria:
 - 1) Do no significant harm to any of the other taxonomy’s environmental objectives or to the wider environment; and
 - 2) Remedial measures to transition.

The **Plus Standard** covers, as a first step, a list of focus sectors:

- 1) Six material sectors (based on their GHG emissions and gross value added):

- 1) Agriculture, forestry and fishing;
 - 2) Electricity, gas, steam and air conditioning supply;
 - 3) Manufacturing;
 - 4) Transportation and storage;
 - 5) Water supply, sewerage and waste management; and
 - 6) Construction and real estate
- 2) Three enabling sectors that help to achieve the environmental objectives:
 - 1) Information and communication;
 - 2) Professional, scientific and technical activities; and
 - 3) Carbon capture, storage and utilization.

The taxonomy provides a decision-making framework⁶ that classifies activities according to whether they are:

- Green Foundation Framework (Green FF);
- Amber Foundation Framework (Amber FF);
- Red Foundation Framework (Red FF);
- Green Plus Standard (Green PS);
- Amber Plus Standard (Amber PS); or
- Red Plus Standard (Red PS).

The ASEAN taxonomy document provides some examples of concrete activities and decision-making assessments.

In addition, the Plus Standard will, in steps, develop thresholds and technical screening criteria for each activity according to various decarbonizing pathways. This will allow decarbonization to proceed at different speeds and in phases as ASEAN members adapt to their unique circumstances.

5 See also Module 4. Sources: ASEAN. (November 2021). ASEAN Taxonomy for Sustainable Finance; ASEAN. (10 November 2021). Press release: “ASEAN Sectoral Bodies Release ASEAN Taxonomy for Sustainable Finance – Version 1”. Available at: <https://asean.org/asean-sectoral-bodies-release-asean-taxonomy-for-sustainable-finance-version-1/>; Regulation Asia. (11 November 2021). “ASEAN Sectoral Bodies Publish Taxonomy for Sustainable Finance”, ESG Investor. Available at: <https://www.esginvestor.net/asean-sectoral-bodies-publish-taxonomy-for-sustainable-finance/>.

6 ASEAN. (November 2021). ASEAN Taxonomy for Sustainable Finance, pp. 40–47.

4) PROVISIONS THAT AVOID UNINTENDED CONSEQUENCES

A taxonomy that defines and focuses on one particular sustainability objective can cause, damage or undermine other sustainability objectives or have other negative impacts.

Activities based on a single objective can not only result in reputational damage for the company implementing the activity or project, and its financier (bank or investor), but can also lead to protests, lawsuits or financial fines that cause the activity or project to be halted and/or lose the money that was loaned or invested.

A typical example is building a wind farm that generates energy without fossil fuel emissions, but it is built in a natural reserve in a way that biodiversity is disrupted, the Indigenous peoples who live there are not consulted and the workers are exploited.

To avoid unintended negative consequences, a taxonomy can incorporate:

- **A minimum safeguard clause:** An example of a minimum safeguard for other environmental standards is the required application of policies and/or practices to not damage biodiversity or water quality. A minimum social safeguard in any taxonomy requires that an activity, project or company avoids breaching human rights and global labor standards.
- **A principle of doing no significant harm** to any of the other objectives or categories in the taxonomy. For example, the EU taxonomy includes, per listed activity, details of how activities categorised under one of the objectives (e.g. climate change) cannot do significant harm to any of the other five objectives (e.g. biodiversity, pollution, circular economy, water, climate adaptation).
- **A list of prohibited** activities, projects or companies to avoid that they might be considered as aligned with the taxonomy.

REMARKS

Provisions that avoid unintended consequences and prevent unexpected problems, damage and financial losses, make a taxonomy more robust. However, they also make it more complex for an activity, project or company to comply with all the taxonomy's requirements and companies and financiers might find it too difficult to align with the taxonomy.



5) AN EFFECTIVE TAXONOMY OR A TAXONOMY WITH LOOPHOLES

One of the main reasons to establish a taxonomy is to avoid the claim that activities, projects, companies and their lenders and investors, are achieving certain objectives but in fact contribute little. This so-called “greenwashing” means that a taxonomy will not orient financing to the objectives very effectively and that it contains major loopholes.

A general taxonomy without provisions that avoid unintended consequences will therefore be less effective at achieving the general objectives and principles.

To avoid loopholes or greenwashing, a taxonomy can include the following provisions:

- **Clarification** of whether a described activity, project or company is transitioning to (within a set period), or already applies, all the principles or technical criteria.
- **A list of activities, projects or category of companies** that are not aligned with the objective, for example, the prohibition of coal-and oil-related activities in a taxonomy with a climate mitigation objective.
- **A requirement that a company** that operates an activity or project in line with a taxonomy, discloses or, better, is prohibited from operating activities and projects contrary to the taxonomy’s objectives (except if the company has clearly defined transition strategies). An example is an oil company that receives financing according to a climate taxonomy for a wind farm project while continuing to drill new oil wells.



HOW TO BALANCE EFFECTIVENESS WITH USAGE?

- The more prescriptive and science-based a taxonomy is, the better it will ensure that the activities, projects and companies achieve the stated objectives and have no loopholes, greenwashing or unintended consequences.
- When a taxonomy is too complex, it might do little to attract financing for its objectives or reorient finance away from harmful activities, projects or companies (except when the taxonomy is mandatory). When it is costlier to adhere to all criteria and attract financing for taxonomy-aligned activities, projects or companies, other factors come into play, such as whether the taxonomy is accompanied by simple guidelines or explanatory instruments, incentives or other promotional instruments, or how the taxonomy is supported, legislated and supervised (see the next modules).

6) A FIXED TAXONOMY OR FLEXIBLE TAXONOMY?

The definitions in a taxonomy, whether broad or detailed, will be determined at a particular point in time and based on existing knowledge and situations (such as acceleration in climate change or social inequality, technologies, political will and other factors). This could mean that the definitions are incomplete or the technical screening criteria do not adhere to the best standards.

A fixed taxonomy – one that is intended to be used for a long time – might not be well adapted to current needs and the best ways to achieve its stated or new objectives. However, a flexible taxonomy would allow changes to be made that improve the effectiveness and robustness of the taxonomy, the ability to achieve the stated objectives or to add new objectives.

Flexibility can be incorporated in a taxonomy by:

- Including provisions that can **complement** a taxonomy with objectives, categories, (sub-) sectors and definitions of activities, projects or companies, after the taxonomy is adopted.
- Including provisions to regularly review the taxonomy at set times in the future and update the definitions (**review clause**).
- Allowing changes to be made, preferably **based on an evaluation** of the extent to which the use of the taxonomy has contributed to achieving its objectives and attracted capital to do so.

An example of a flexible taxonomy is the ASEAN taxonomy, which is “intended to be a living document that is constantly reviewed in line with technological, scientific, social and economic development”.⁷



CHALLENGES

- When a taxonomy changes many times or within a short period of time, the question becomes how investments or loans that were based on the previous requirements will be treated. They may be perceived as less valuable, but some investments in new technologies take a long time to become profitable and need to attract long-term financing. A solution is to “grandfather” such activities, projects or companies, and their investments or loans, so they are still accepted as aligned with the taxonomy. However, such investments and loans may not contribute as much to the objectives.
- Since adopting changes can be a long and difficult process (see Module 2 on decision-making), there is an argument for being ambitious when initiating a taxonomy and meeting the so-called “gold standard”.

⁷ Regulation Asia. (11 November 2021). “ASEAN Sectoral Bodies Publish Taxonomy for Sustainable Finance”, ESG Investor. Available at: <https://www.esginvestor.net/asean-sectoral-bodies-publish-taxonomy-for-sustainable-finance/>.

7) ADAPT AN EXISTING TAXONOMY OR DESIGN A NEW ONE?

Given that some countries or regions have already legislated (e.g. the EU), regulated (e.g. Bank Negara Malaysia), presented for voluntary use (e.g. Indonesia) or proposed (e.g. Philippines, ASEAN) a taxonomy, a new taxonomy can imitate or adopt some of the same characteristics of an existing taxonomy.

Adopting or adapting an existing taxonomy avoids designing a taxonomy from scratch. It would also make the new taxonomy more compatible with taxonomies in other parts of the world, contributing to a harmonised and comparable global taxonomy system that is more accessible and less costly for foreign financiers.

When a new taxonomy is based on an existing taxonomy, it can differentiate itself by:

- Adapting the taxonomy's objectives, categories or sectors and definitions to the needs and characteristics of a country (e.g. high dependency on coal-based power generation that needs to be phased out, vulnerability to climate change due to long coastlines that can flood, or be affected by drought);
- Adapting the taxonomy in a proportional way to ensure that the requirements can be easily met given the level of economic development in the country or region;
- Adding specific sectors that are important to the domestic economy and have special transition needs (e.g. palm oil);
- Using the same objectives as existing taxonomies, but providing other detailed requirements; and
- Developing new objectives or technical screening criteria that are important for the country (e.g. social objectives such as eliminating child labor).

Several attempts have been made to create a common taxonomy, especially the EU-China Common Ground and the ASEAN taxonomy.⁸

Other related sustainable finance processes:

Because green bonds have already been in the market for some time, various business associations and regulators have, sometimes in general terms, identified or regulated what activities or projects or companies can be financed by green bonds (e.g. ICMA Green Bond Principles, ASEAN Green Bond Standards).

The list of activities or projects, and some of the criteria, are very similar to what a taxonomy defines, and can be or, in some cases, already are used in a taxonomy's definitions, activities or sectors.

REMARKS

- The global financial industry, which invests in countries around the world, prefers to have identical taxonomies in as many countries as possible to avoid the cost of adapting their assessments of potential aligned investments to different jurisdictions. The industry therefore argues against so-called "regulatory fragmentation" so that countries could attract more easily foreign investments and loans.
- When adapted to domestic characteristics, objectives and needs, a country can attract private financing for national plans to meet its Paris climate goals and develop sustainably. It might also be easier to mobilize domestic lenders and investors. However, it might be more difficult to convince foreign investors that a country-adapted taxonomy of developing countries is as good an investment as activities covered by a taxonomy from a country with an advanced economy.
- A standard developed by the private financial sector can become official, such as with the ASEAN Green/Social/ Sustainability Bonds/Sukuk Bond Standards, which are integrated in some Asian taxonomy developments.



⁸ For information about the ASEAN taxonomy, see Module 4. To learn about the EU-China common ground for a taxonomy, see: International Platform on Sustainable Finance. (November 2021). Common Ground Taxonomy – Climate Change Mitigation – Instruction Report. Available at: https://ec.europa.eu/info/files/international-platform-sustainable-finance-common-ground-taxonomy-report-2021_en.

REVIEW QUESTIONS & EXAMPLE OUTLINE OF A TAXONOMY

REVIEW QUESTIONS

- How, in simple terms, would you explain a taxonomy for sustainable finance to your friends?
- Can you list some different objectives that can be included in a taxonomy? Do you have a preference for certain objectives?
- What can be concretely defined and described by a taxonomy?
- How does a taxonomy help to select activities, projects or companies that are aligned with the taxonomy?
- What can be some of the pitfalls or loopholes in a taxonomy?
- Can a taxonomy be changed?

EXAMPLE OUTLINE OF A TAXONOMY

- Policy objectives outlined in a preamble.
- Provisions stating general or concrete objectives.
- Provisions describing principles, requirements and technical details that are to be used for each activity financed in alignment with the taxonomy.
- Chapters or a list of economic sectors to be covered by the taxonomy.
- Lists of concrete (economic) activities, projects and/or companies classified by sector, and descriptions in each activity of how to fulfill the objective(s), principles, requirements and technical screening criteria.



ANNEX I:

Example of the EU definition of “construction of new buildings”⁹ categorised under the sub-services sector “construction and real estate activities” for the climate change mitigation objective in the EU environmental taxonomy

DESCRIPTION OF THE ACTIVITY “CONSTRUCTION OF NEW BUILDINGS”

Development of building projects for residential and non-residential buildings by bringing together financial, technical and physical means to realise the building projects for later sale as well as the construction of complete residential or non-residential buildings, on own account for sale or on a fee or contract basis.

The economic activities in this category could be associated with several NACE codes, in particular F41.1 and F41.2, including also activities under F43, in accordance with the statistical classification of economic activities established by Regulation (EC) No 1893/2006.

TECHNICAL SCREENING CRITERIA

A. SUBSTANTIAL CONTRIBUTION TO CLIMATE CHANGE MITIGATION

Constructions of new buildings for which:

1. The Primary Energy Demand (PED), defining the energy performance of the building resulting from the construction, is at least 10% lower than the threshold set for the nearly zero-energy building (NZEB) requirements in national measures implementing Directive 2010/31/EU of the European Parliament and of the Council. The energy performance is certified using an as-built Energy Performance Certificate (EPC).
2. For buildings larger than 5,000 m², upon completion, the building resulting from the construction undergoes testing for air-tightness and thermal integrity, and any deviation in the levels of performance set at the design stage or defects in the building envelope are disclosed to investors and clients. As an alternative; where robust and traceable quality control processes are in place during the construction process this is acceptable as an alternative to thermal integrity testing.

3. For buildings larger than 5,000 m², the life-cycle Global Warming Potential (GWP) of the building resulting from the construction has been calculated for each stage in the life cycle and is disclosed to investors and clients on demand.

B. DO NO SIGNIFICANT HARM (DNSH) TO:

(1) Climate change adaptation:

The activity complies with the criteria set out in Appendix¹⁰ A in the EU document.

(2) Sustainable use and protection of water and marine resources:

Where installed, except for installations in residential building units, the specified water use for the following water appliances are attested by product datasheets, a building certification or an existing product label in the Union, in accordance with the technical specifications laid down in Appendix E in the EU document:

- (a) wash hand basin taps and kitchen taps have a maximum water flow of 6 litres/minute;
- (b) showers have a maximum water flow of 8 litres/minute;
- (c) WCs, including suites, bowls and flushing cisterns, have a full flush volume of a maximum of 6 litres and a maximum average flush volume of 3,5 litres;
- (d) urinals use a maximum of 2 litres/bowl/hour. Flushing urinals have a maximum full flush volume of 1 litre.

To avoid impact from the construction site, the activity complies with the criteria set out in Appendix B in the EU document.

(3) Transition to a circular economy:

At least 70% (by weight) of the non-hazardous construction and demolition waste (excluding naturally occurring material referred to in category 17 05 04 in the European List of Waste established by Decision 2000/532/EC) generated on the construction site is prepared for reuse, recycling and other material recovery, including backfilling operations using waste to substitute other materials, in accordance with the waste hierarchy and the EU

⁹ European Commission. (4 June 2021). Commission Delegated Regulation (EU) supplementing Regulation (EU) 2020/852 of the European Parliament and of the Council by establishing the technical screening criteria for determining the conditions under which an economic activity qualifies as contributing substantially to climate change mitigation or climate change adaptation and for determining whether that economic activity causes no significant harm to any of the other environmental objectives. pp. 166-169. Available at: https://eur-lex.europa.eu/resource.html?uri=cellar:d84ec73c-c773-11eb-a925-01aa75ed71a1.0021.02/DOC_2&format=PDF. The many footnotes added to the criteria are not mentioned in this example.

¹⁰ Ibidem, pp. 189-194: the Appendix provides general requirements for the principle DNSH for each of the objectives (2) to (6) of the EU taxonomy.

Construction and Demolition Waste Management Protocol. Operators limit waste generation in processes related to construction and demolition, in accordance with the EU Construction and Demolition Waste Management Protocol and taking into account best available techniques and using selective demolition to enable removal and safe handling of hazardous substances and facilitate reuse and high-quality recycling by selective removal of materials, using available sorting systems for construction and demolition waste.

Building designs and construction techniques support circularity and in particular demonstrate, with reference to ISO 20887 or other standards for assessing the disassemblability or adaptability of buildings, how they are designed to be more resource efficient, adaptable, flexible and dismantlable to enable reuse and recycling.

(4) Pollution prevention and control:

Building components and materials used in the construction comply with the criteria set out in Appendix C in the EU document.

Building components and materials used in the construction that may come into contact with occupiers emit less than 0,06 mg of formaldehyde per m³ of material or component upon testing in accordance with the conditions specified in Annex XVII to Regulation (EC) No 1907/2006 and less than 0,001 mg of other categories 1A and 1B carcinogenic volatile organic compounds per m³ of material or component, upon testing in accordance with CEN/EN 16516291 or ISO 16000-3:2011 or other equivalent standardised test conditions and determination methods.

Where the new construction is located on a potentially contaminated site (brownfield site), the site has been subject to an investigation for potential contaminants, for example using standard ISO 18400.

Measures are taken to reduce noise, dust and pollutant emissions during construction or maintenance works.

(5) Protection and restoration of biodiversity and ecosystems:

The activity complies with the criteria set out in Appendix D in the EU document.

The new construction is not built on one of the following:

- (a) arable land and crop land with a moderate to high level of soil fertility and below ground biodiversity as referred to the EU LUCAS survey;
- (b) greenfield land of recognised high biodiversity value and land that serves as habitat of endangered species (flora and fauna) listed on the European Red List or the IUCN Red List;
- (c) land matching the definition of forest as set out in national law used in the national greenhouse gas inventory, or where not available, is in accordance with the FAO definition of forest.

ANNEX II:

Example of the “Climate Change and Principles-based Taxonomy” by the Central Bank of Malaysia (Bank Negara Malaysia) issued on 30 April 2021¹¹

THE TAXONOMY HAS FIVE GUIDING PRINCIPLES

Guiding Principle 1: Climate change mitigation

Guiding Principle 2: Climate change adaptation

Guiding Principle 3: No significant harm to the environment

Guiding Principle 4: Remedial measures to transition

Guiding Principle 5: Prohibited activities

Each guiding principle is described in short with some examples, as is the case for Guiding Principle 1.

GUIDING PRINCIPLE 1 (GP1): CLIMATE CHANGE MITIGATION

The objective of climate change mitigation is to reduce or prevent emission of GHG into the atmosphere. An economic activity can be considered to meet climate change mitigation if such activity makes a substantial contribution in the following objectives:

- (a) Avoid GHG emissions;
- (b) Reduce GHG emissions; or

- (c) Enable others to avoid or reduce GHG emissions.

Common climate change mitigation activities include, but are not limited to, generation of renewable energy, rehabilitation, retrofitting and/or replacement of energy-inefficient technology and/or production of energy-efficient technologies as well as maintenance and strengthening of land-based carbon stock and sinks¹⁷, above and below ground. The activity should demonstrate the capability to avoid or reduce GHG emissions compared to the baseline scenario without the mitigating action. Examples of the application of GP1 are provided in Table A.

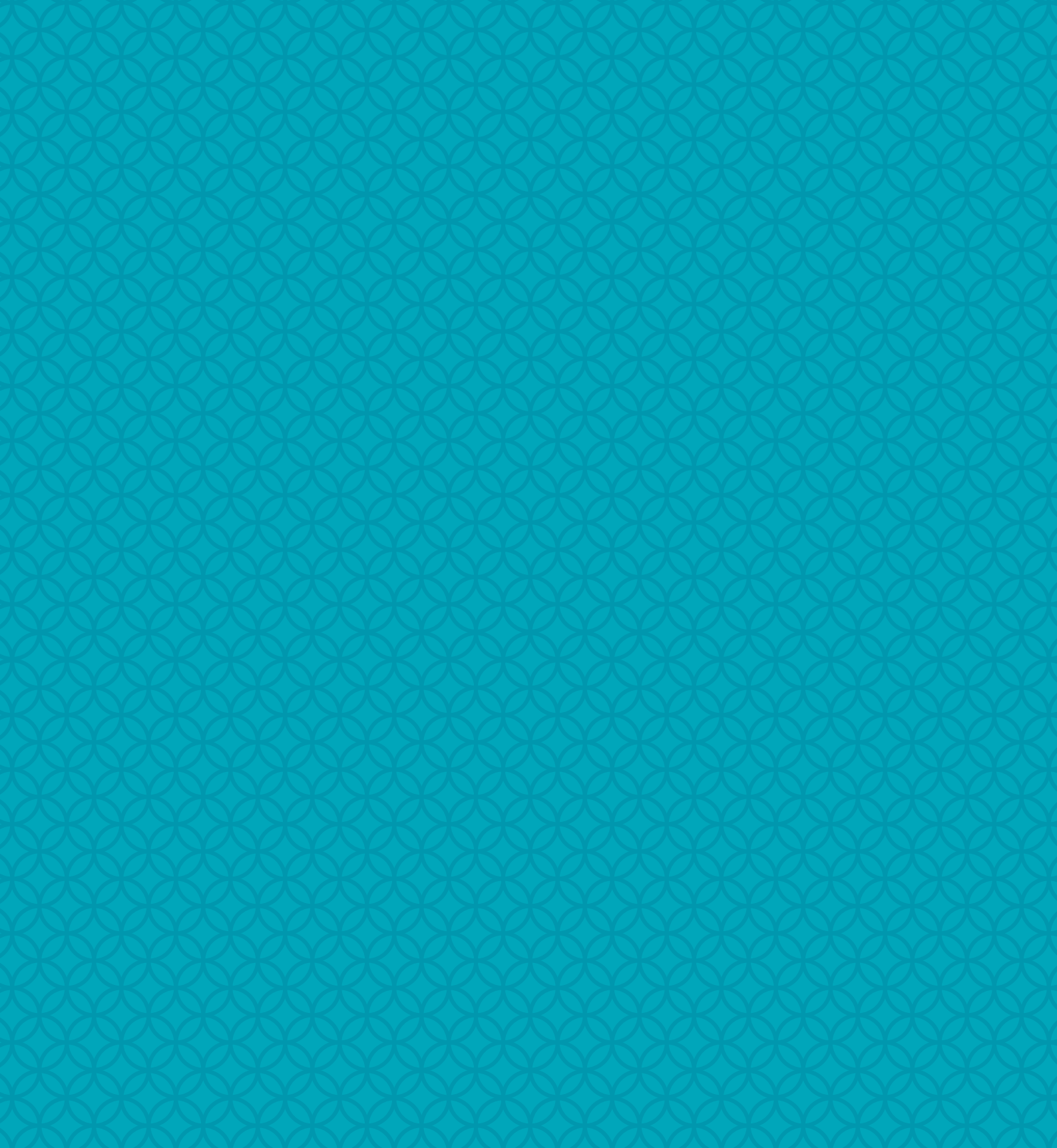
An economic activity, while contributing to climate change mitigation, should not cause significant negative impact on the broader environment. Further examples of economic activities that generally meet GP1 are provided in Appendix 3 of the Malaysian document.

In addition to the examples below, the taxonomy also provides other “use cases”.

TABLE A: EXAMPLES ON THE APPLICATION OF GP1:

ECONOMIC ACTIVITY	EXAMPLES	MEASUREMENTS
Renewable energy	<ul style="list-style-type: none"> • Onshore and/or offshore wind power generation • Onshore and floating solar photovoltaic (PV) power generation 	<ul style="list-style-type: none"> • The IFR approach 18 to GHG accounting for renewable energy projects can be used to measure GHG emissions associated with production of electricity at a wind farm, solar farm or hydro power plant. • These activities are assumed to reduce CO₂ emission by comparing against emissions under an alternative scenario without the project.
Rehabilitation, retrofitting and/or replacement with energy-efficient technology	<ul style="list-style-type: none"> • Replacement of existing heating/cooling systems in buildings with non-fossil fuel powered systems • Energy-efficient vehicles and transport (e.g. hybrid cars) 	<ul style="list-style-type: none"> • The IFR approach to GHG accounting for energy-efficient economic activities can also be used to measure GHG emissions associated with investments in improvement of energy efficiency. • These activities are assumed to reduce CO₂ emissions by comparing against existing emissions.
Restoring, maintaining, conserving and strengthening of natural land-based carbon stock and sinks (for LULUCF only)	<ul style="list-style-type: none"> • Avoidance/ suspension of deforestation • Afforestation and reforestation • Restoration or rehabilitation of forests, croplands, peatlands, grasslands and wetlands • Sustainable forest and agricultural management • Forest and peatland conservation 	<ul style="list-style-type: none"> • Guidance on forest, soil and biomass GHG accounting are provided by: <ul style="list-style-type: none"> - LULUCF GHG Protocol; - Guidelines for National GHG Inventories by the IPCC; and - CDP disclosure framework and system. • These activities are assumed to avoid or reduce CO₂ emissions by comparing against existing emissions.

¹¹ Bank Negara Malaysia. (30 April 2021). Climate Change and Principle-based Taxonomy, pp. 12–14. Available at: <https://www.bnm.gov.my/documents/20124/938039/Climate+Change+and+Principle-based+Taxonomy.pdf>.



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