



Building Shared Language for Green and Sustainable Finance -

Expert Briefing on the Development of Taxonomies

The International Network of Financial Centres for Sustainability (FC4S)

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1. The Need for Shared Language: Recent developments and critical issues

New fields of human activity need clear classification to enable participants to operate with clarity and efficiency. In science, a taxonomy deals with the description, identification, naming, and classification of different activities. The rapid growth of green and sustainable finance is now generating the development of taxonomies to underpin future expansion.

Across the world, banks, investors, insurers and stock exchanges are seeking to align their capital allocation decisions, product development, service provision and institutional strategies with new risks and opportunities associated with the transition to sustainable development. Market momentum on sustainable finance has increased markedly across asset classes and jurisdictions: annual issuance of labelled green bonds increased over fourteen times from 2013 to 2017, rising from \$11 to \$155 billionⁱ with up to \$250 billion expected in 2018ⁱⁱ.

A number of recent developments suggest that sustainable finance has reached an inflection point in its importance across financial and capital markets. These include the recommendations of the Task Force on Climate-related Financial Disclosuresⁱⁱⁱ; the establishment of the central bank and supervisor Network for Greening the Financial System^{iv}; and the launch of ambitious national and regional strategies for green and sustainable finance, for example in Canada^v, China^{vi}, the EU^{vii}, Morocco^{viii} and other countries^{ix}.

The Pivotal Role of Financial Centres

Financial centres are at the heart of this shift as they are the places where the demand and supply of capital of sustainable finance comes together. A growing number of leading global hubs have been taking action on green and sustainable finance, with the aim of promoting market growth, improving financial centre competitiveness, aligning financial flows with policy objectives and, ultimately, improving the connectivity between the financial sector with the changing needs of a real economy in transition^x. Importantly, for the world's financial centres, sustainability is not just focused on the growth in specific green or social products, but also about driving a shift towards sustainable practices across the entire economy.

To harness the power of place that comes together in the world's leading hubs, the network of Financial Centres for Sustainability was launched in September 2017. One of the priority issues facing the members of the network is the core question of definition and taxonomy.



Critical Questions for Green and Sustainable Finance: why, how to and what?

The “why” of sustainable finance is now clear in many markets. Public and private institutions, as well as civil society, are now focusing on “how to”. As part of this, a fundamental question is “what” – specifically, what economic activities, financial assets, products and services can be considered green and sustainable? To enable this to be answered, financial markets need a shared language to operate effectively.

This need is especially felt by policy makers, who are confronting pressure from investors, NGOs and consumers/citizens to take action to remove barriers to sustainable finance, and possibly incentivize capital flows towards sustainable assets^{xi}. Having a shared language in place will enable the world to achieve its climate and sustainable development goals faster, cheaper and more smoothly. As a result, it is critically important that these taxonomies and classification systems are designed and applied in ways that can rapidly unlock financial markets for sustainable development.

2. Building a shared language: efforts to date

There is no universally accepted definition, taxonomy or standard for investments, transactions, financial products and services that can be considered “sustainable”. At present, a multitude of different approaches exist for promoting green, environmental, social, impact, ethical, responsible and sustainable finance.

In general, these efforts to develop a shared language tend to operate in four intersecting dimensions:

- i. **Levels:** sustainable finance stretches from the system level down to individual assets and transactions. It relates to the integration of environmental, social and governance (ESG) factors into all financial activities as well as specific green and social products.
- ii. **Process:** sustainable finance involves a range of processes to ensure the integrity and credibility of decision-making. Looking An example of a process-based approach is the ICMA Green Bond Principles^{xii}, which sets out a standard approach for issuance of green bonds, involving the use of proceeds, evaluation, management of proceeds, reporting and external review.
- iii. **Performance:** sustainable finance also involves ensuring that financial activities contribute to the improvement of environmental and social conditions. One way this can be done is by setting performance thresholds that need to be achieved. An example of a verification approach is the Climate Bonds Standard^{xiii}, which sets out a certification process, pre-issuance requirements, post-issuance requirements and a suite of sector-specific eligibility requirements.
- iv. **Connectivity:** sustainable finance connects financial activities with economic activities in the real world. Importantly, this means that classifications and taxonomies of sustainable finance need to be consistent with the way in which data on environmental and social issues are collected, tracked and reported by a variety of institutions in the



real economy, not least businesses as well as government agencies, such as statistical bodies.

The development of definitions and taxonomies is being led by a range of public, private, and third-sector organisations, which have focused on different thematic areas (i.e. climate change, labour standards) and asset classes (i.e. banking, investment). The Principles for Responsible Investment set out high-level definitions for best practices with respect to ESG factors in the investment industry and are now adopted by more than 2000 institutions with US\$83 trillion in assets under management. More recently, leading pension funds have released taxonomies for Sustainable Development investments^{xiv}. In debt markets, key initiatives include the ICMA Green Bond^{xv} and Social Bond Principles^{xvi}, the CBI Climate Bonds Standard^{xvii} and the recent LMA-APLMA Green Loan Principles^{xviii}. Major multilateral financial institutions have also developed common approaches to measuring climate finance, notably the MDB-IDFC Common Principles for Climate Finance Tracking^{xix}. Some stock exchanges are also starting to monitor the green revenues of listed companies^{xx}.

A number of governments and financial regulators have also started to introduce their own requirements. Two initiatives stand out in particular: the first is China's Green Bond Endorsed Project Catalogue, released in 2015^{xxi}; the second is the European Commission's 2018 proposal to establish a unified classification system for sustainable economic activities^{xxii}. At the international level, there is action underway by the International Standards Organization to establish a Technical Committee to explore aspects of standardization in sustainable finance^{xxiii}.

This range of approaches to a common question – ‘what is sustainable?’ – reflects the diversity of different organisations and perspectives involved, and the relatively early stage of development. Yet there is concern that a proliferation of conflicting efforts could bring confusion and set back progress with sustainable finance. Initial efforts have been undertaken to compare how definitions and taxonomies may relate to each other^{xxiv}, but no comprehensive assessment has been made.

3. Setting Principles for Classifying Green and Sustainable Finance

This review shows that developing a shared language for sustainability can be a valuable public good for the world's financial system. It is in the core interest of the world's financial centres that different to develop definitions, taxonomies, and standards efforts converge to a high standard of compatibility.

The reasons are clear – a robust, well-designed, and internationally compatible taxonomy (or set of taxonomies) could help to:

- Reduce transaction costs for green and sustainable finance,
- Provide the foundation for multiple standards, products and asset classes,
- Build market trust, foster liquidity, and facilitate cross-border flows,
- Allow financial consumers to express their sustainability preferences,



- Enable regulators to refine requirements,
- Provide a basis for policymakers to adjust incentives and other measures,
- Ultimately, accelerate the transition to a sustainable economy.

To help achieve this convergence, the Network has pooled its collective experience and proposes the following principles to guide the development of definitions, taxonomies and classifications of green and sustainable finance:

1. Scope: An important first step is to clarify the scope of the taxonomy with respect to sustainability themes, frameworks, and definitions – for instance, Environmental, Social and Governance (ESG) factors, green investments and sectors, climate change or other factors. At the highest level, the Sustainable Development Goals provide a universal framework within which classifications can be developed. For practical reasons or matters of mandate, specific initiatives may choose to develop taxonomies which address a specific segment of sustainable development, such as green or climate finance.

2. Purpose: Identifying the purpose and the different uses of a taxonomy is vital. Applications of taxonomies could include: ensuring consistency of the terms used in corporate reporting on real economy activities; promoting growth of new dedicated sustainable finance asset classes; developing labelled financial products (such as green bonds, which need to meet a certain process and performance threshold); helping to measure financial flows to sustainability-related sectors; or identifying particular assets within broad-based portfolios (such as the share of green revenues in an equity index).

3. Good Practice: International good practice should be drawn upon, both to avoid ‘reinventing the wheel’ and to encourage a convergence of approaches. This will help to avoid unnecessary barriers arising between different markets, and to accelerate the development of taxonomies in new markets. It is important to use existing definitions where applicable, to identify points of compatibility and difference, and to clarify how issues of compatibility can be managed.

4. Evidence: Market participants, public authorities and society need taxonomies that are clear and based on rigorous evidence. For environmental issues, taxonomies should be based on the best available science. For example, classifications for climate-change related economic activities or financing should be compliant with the Paris Agreement on Climate Change, and aligned with mitigation targets or resilience objectives. A strong empirical evidence base is a critical foundation for good capital allocation decisions, and can help ensure policy alignment between relevant financial and economic policies.

5. Proportionality: The development of sustainable finance taxonomies needs to be proportionate, notably in terms of time and cost. Processes need to recognise the urgent need to accelerate sustainable finance. This means considering the sequencing of the different phases of taxonomy development, from higher-level classifications to more granular and comprehensive standards and labels, so that progress is not held back and costs are not excessive.



6. Mechanisms: The design of taxonomies – and the labels and standards that may follow – need to balance the use of voluntary vs. mandatory mechanisms for implementation. It is important to understand which mechanisms may be appropriate to address different types of market gaps, barriers, and policy objectives.

7. Dynamism: Taxonomies should be dynamic to allow financial markets to reflect the fast-moving development in technologies and solutions in the real economy, as well as developments within the financial sector itself. This could involve an annual review process informed by scientific developments and market practice.

8. Consequences: Taxonomies need to be carefully designed so that they do not have unintended consequences that could hamper the development of the market – for example, by disproportionately increasing transaction costs for green and sustainable finance products, or accelerating the stranding of assets^{xxv}. One potential way of avoiding this is to apply parallel focus on assets and activities that damage the environment, have negative social impacts, are not aligned with the Paris Agreement or the SDGs, and ultimately compromise sustainable development objectives.

9. Coordinated: Classification frameworks for sustainable financial activities and assets need to be closely coordinated with other areas of market transparency and disclosure. In a climate change context, this could include the reporting recommendations of the FSB TCFD. In particular, real economy enterprises and issuers should be encouraged to adopt classification systems in their annual reporting so that there is a clear read-across with the efforts of financial institutions.

10. Transparent: To enable market efficiency, the procedures and results of the classification process should be as transparent as possible. This is important to allow market participants to determine whether taxonomy instruments are implementable (i.e. at all likely to be successful in practice), fit-for-purpose (i.e. reflecting relevant priorities), and aligned with both market and policy objectives.



About the FC4S Network

The FC4S is a partnership between leading financial centres and the United Nations Environment Programme, which acts as its Convenor and Secretariat. The objective of the Network is to enable financial centres to exchange experience, drive convergence, and take action on shared priorities to accelerate the expansion of green and sustainable finance. Following from endorsement by G7 Environment Ministers under the 2017 Italian G7 Presidency, the FC4S Network was launched in September 2017 with the support of the Italian Ministry of Environment, Land, and Sea. The Network is headquartered in Geneva, Switzerland.

Current members of the Network include:

- **Astana:** Astana International Financial Centre
- **Casablanca:** Casablanca Finance City Authority
- **Dublin:** Sustainable Nation Ireland
- **Frankfurt:** Green and Sustainable Finance Cluster Germany
- **Geneva:** Sustainable Finance Geneva
- **Hong Kong:** Green Finance Task Force
- **London:** City of London Green Finance Initiative
- **Luxembourg:** Luxembourg for Finance
- **Liechtenstein:** Liechtenstein Bankers Association
- **Milan:** Centro Finanziario Italiano per la Sostenibilita (CFIS)
- **Paris:** Finance for Tomorrow
- **Seoul:** Seoul Metropolitan Government
- **Shanghai:** Lujiazui Financial City
- **Shenzhen:** Shenzhen Green Finance Committee
- **Stockholm:** Stockholm Green Digital Finance
- **Toronto:** Toronto Finance International
- **Zurich:** Swiss Sustainable Finance

Partner organisations include:

- Climate Bonds Initiative
- Climate-KIC
- Principles for Responsible Investment
- Sustainable Stock Exchange Initiative
- UNEP Finance Initiative

For further information, see www.fc4s.org, or contact Jeremy McDaniels (Head of Project, FC4S Network), at Jeremy.McDaniels@un.org.



Endnotes

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- ⁱ Climate Bonds Initiative. <https://www.climatebonds.net/>
- ⁱⁱ <https://www.bloomberg.com/professional/blog/blossoming-green-bond-market-growing-toward-250-billion-year/>
- ⁱⁱⁱ <https://www.fsb-tcfd.org/publications/final-recommendations-report/>
- ^{iv} <https://www.banque-france.fr/en/financial-stability/international-role/network-greening-financial-system>
- ^v <https://www.canada.ca/en/environment-climate-change/services/climate-change/expert-panel-sustainable-finance.html>
- ^{vi} <http://www.pbc.gov.cn/english/130721/3131759/index.html>
- ^{vii} https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_en
- ^{viii} <http://www.bkam.ma/en/content/view/full/401601>
- ^{ix} <http://documents.worldbank.org/curated/en/903601510548466486/pdf/12128312112017153333-RoadmapforaSustainableFinancialSystem.pdf>
- ^x <http://unepinquiry.org/publication/accelerating-financial-sector-action-on-sustainable-development/>
- ^{xi} So far, a series of market-based attempts at solving the issue of definitions have been made, and applied to investment use cases (in the fixed income, public equity and private equity space. The discrepancies between different market-based solutions are leading policy makers to seek reassurance through official definitions of what is ‘green’.
- ^{xii} <https://www.icmagroup.org/green-social-and-sustainability-bonds/green-bond-principles-gbp/>
- ^{xiii} <https://www.climatebonds.net/standards/about>
- ^{xiv} <https://www.apg.nl/en/publication/SDI%20Taxonomies/918>
- ^{xv} <https://www.icmagroup.org/green-social-and-sustainability-bonds/green-bond-principles-gbp/>
- ^{xvi} <https://www.icmagroup.org/green-social-and-sustainability-bonds/social-bond-principles-sbp/>
- ^{xvii} https://www.climatebonds.net/standards/standard_download
- ^{xviii} <http://www.lma.eu.com/news-publications/press-releases?id=146>
- ^{xix} http://www.eib.org/attachments/documents/mdb_idfc_mitigation_common_principles_en.pdf
- ^{xx} <https://www.ftse.com/products/indices/green-revenues>
- ^{xxi} <http://greenfinance.org.cn/displaynews.php?cid=79&id=468>
- ^{xxii} https://ec.europa.eu/info/law/better-regulation/initiatives/com-2018-353_en
- ^{xxiii} http://www.jisc.go.jp/international/nwip/tsp274_Sustainable_Finance_Proposal_Final.pdf
- ^{xxiv} <http://www.eib.org/infocentre/press/releases/all/2017/2017-311-joint-white-paper-by-china-green-finance-committee-and-eib-set-to-strengthen-international-green-bond-market.htm>
- ^{xxv} This outcome would be in conflict with the principles informing the TCFD. Another concern expressed by policy makers is that taxonomy might have the unintended consequence of distorting competition.