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Global Guiding Principles for Developing Climate Finance Taxonomies

A Key Enabler for Transition Finance

BCG BOSTON
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Contacts



Allison Parent
GFMA
Executive Director
aparent@gfma.org



Scott Goodwin
GFMA
Assistant Vice President
sgoodwin@gfma.org



Rick Watson
AFME
Managing Director, Head of
Capital Markets, Membership
& Events
rick.watson@afme.eu



Tonia Plakhotniuk
AFME
Associate Director
Tonia.Plakhotniuk@afme.eu



Matthew Chan
ASIFMA
Head of Public Policy &
Sustainable Finance
mchan@asifma.org



Melissa MacGregor
SIFMA
Managing Director &
Associate General Counsel
mmacgregor@sifma.org



Roy Choudhury
Boston Consulting Group
Managing Director & Partner,
Capital Markets Lead
Choudhury.Roy@bcg.com



Sophia Kang
Boston Consulting Group
Platinion Manager
Kang.Sophia@bcg.com



Veronica Chau
Boston Consulting Group
Partner & Director,
Sustainable Finance
Chau.Veronica@bcg.com



Gwenhael Le Boulay
Boston Consulting Group
Managing Director & Senior
Partner
LeBoulay.Gwenhael@bcg.com



Dean Frankle
Boston Consulting Group
Managing Director and
Partner
Frankle.Dean@bcg.com



Dave Sivaprasad
Boston Consulting Group
Managing Director and
Partner
Sivaprasad.Dave@bcg.com

Executive Summary

The global economy must fundamentally transform in order to achieve the ambitions set out to further the Paris Agreement and other emerging international commitments¹. This transformation will require coordination across all sectors and regions, as well as considerable investment, estimated at \$100–150 trillion by 2050. Climate-Aligned finance will need to scale exponentially to support investments across all regions and sectors of the global economy. Globally harmonized, objective, science-based taxonomies will be key enablers in scaling Climate-Aligned Finance. The taxonomies and financing must go beyond the use-of-proceeds model, to include a broader set of investments that account for entity-level activities and a broad range of financial instruments. Taxonomies will be essential for determining whether investments in these activities are aligned with climate goals and science-based transition pathways. However, due to regional and sectoral nuances, pathways to transition will be different across jurisdictions and industries. For this reason, a single global taxonomy is unlikely to be viable; however, a consistent set of global principles can be applied across all jurisdictions and industries to ensure activities are aligned with Paris goals. The principles set out in this paper address the principles and considerations needed to develop the globally consistent and comparable taxonomies essential for supporting a Climate-Aligned Finance.

We recommend five key global guiding principles to be considered in the development and the enhancement of global Climate Finance taxonomies, including:

- I. Climate Finance taxonomies should be broadened beyond use of proceeds to capture entity-level activities and all eligible sources of capital.
- II. Climate Finance taxonomies should be objective in nature, supported by clearly defined metrics and thresholds aligned to the Paris Agreement, and science-based targets.
- III. Climate Finance taxonomies should have a consistent set of principles and definitions, but provide flexibility for regional and temporal variation to align with differences in transition pathways.
- IV. Climate Finance metrics should be defined and applied to sectors using science-based targets, balancing ease of use with transparency and robustness to both assess climate impact and support third-party verification.
- V. Climate Finance taxonomies should be based on a governance process that is robust, inclusive, and transparent, and has the flexibility for continued evolution.

Climate Finance taxonomies should use science-based transition pathways; metrics and thresholds should be informed by regional and sector transition targets; each intended use case should be clearly outlined; and its use in financial products and transactions should be disclosed and supported by robust independent verification to avoid the potential risk of greenwashing.

Global policymakers, standard setters, and market participants should agree on a minimum set of global guiding principles and definitions to underpin taxonomies across regions. Further, policymakers, standard

¹ Such as the G7 Finance Ministers 30x30 commitments, May 2021

setters, and individual institutions should align their taxonomies to globally consistent definitions to promote this common understanding. **Perhaps overly ambitious, a "silver bullet" global taxonomy is unlikely to be a solution. However, these global principles can, and should, form the basis for developing sector-specific and, where necessary, region-specific taxonomies that are consistent, comparable, and reliable.**

Climate Finance taxonomies help enable financing, providing guidelines for investors and credit institutions on how “climate-aligned” a given corporate is at the entity level, or the alignment of specific activities undertaken by an entity to science-based pathways. Taxonomies should not be used as proxy for physical, transitional, or prudential risk assessment of financial institutions. A taxonomy captures only a snapshot of a corporate’s activities; therefore, to comprehensively understand a corporate through the lens of Climate Finance, a taxonomy should be used in conjunction with forward-looking decision-relevant metrics, enabled by mandatory disclosures.

1. Global Principles for a Climate Finance Taxonomy

Capital markets are global in nature and involve participants from across the value chain of capital, from asset owners and investors—through intermediaries such as asset managers and banks—to real-economy sectors and corporates. Climate Finance markets will need to scale within the capital markets to meet the \$3–5 trillion+ per year in global investment needed to decarbonize the global economy—with the most significant regional investment demand, estimated at \$66 Trillion over three decades, occurring in Asia.² Seamless and efficient capital flows across all borders will be critical to scaling markets at the unprecedented scale, speed, and geographic scope needed to achieve climate targets.

Today, there is not a consistently applied definition of "climate-aligned" finance, particularly as it relates to transition finance (i.e., activities that may reduce emissions but are not objectively low or near-zero carbon). This uncertainty, coupled with the lack of global guiding principles for the development of Climate Finance taxonomies, leads to both a lack of investment driving increased transaction costs for issuers and the risk of greenwashing for investors.

As per the Organization for Economic Co-operation and Development (OECD), “There are two dimensions to a taxonomy: the system itself in all its complexity, and the final product (boiled down to its pragmatic essentials) as it will be used by financial market participants and other users. Users of taxonomies and definitions are not necessarily interested in understanding why a given metric or threshold must be used for an activity. Rather, they will use the taxonomies and definitions as a final product and screen activities to determine eligibility under the taxonomy.”³

Given the variety of approaches to developing taxonomies, “it is crucial to determine at the outset what a taxonomy is defined to do. The International Capital Markets Association (ICMA) has explained that “taxonomies can serve a variety of different purposes beyond simple classification, as financial product qualification, disclosure, or risk assessment tools (or a combination of several or all of these.”⁴ We agree that the intended use case for a taxonomy must be clearly outlined, particularly if at any point it will be adopted for regulatory purposes. Similarly, we also caution against the use of climate taxonomies for prudential risk management for the financial services sector, as it could lead to unintended consequences (e.g., migration of exposures outside the regulated sector, unexpected repricing of assets, impeding the flow of capital to specific sectors not covered in the taxonomy, etc.).

² GFMA and BCG Report on Climate Finance Markets and the Real Economy, Sizing the Global Need and Defining the Market Structure to Mobilize Capital (December 2020)

³ As per the OECD paper from Oct 2020, “Developing Sustainable Finance Definitions & Taxonomies.”

⁴ See ICMA, “Overview and Recommendations for Sustainable Finance Taxonomies” (May 2021)

Absent global consensus on guiding principles, jurisdictions (government-sponsored), industry associations, and individual participants have each created their own bespoke taxonomies for Climate Finance. **Differing or even contradictory criteria between sector- and region-specific taxonomies can be particularly challenging for a diversified entity that operates across multiple countries, sectors, sub-sectors, global investors, and credit institutions to navigate**, thereby impeding the rapid scaling of investment needed to achieve climate goals.

All existing and new taxonomies should be assessed against these global principles for Climate Finance taxonomies as well as the conclusions factored into shaping future enhancements and development of new taxonomies. The five principles are by design high level and not prescriptive for applications that are based on regional or nationally defined contributions, climate targets and policies, and sector-specific transition pathways. They are designed to be foundational in the development of Climate Finance taxonomies by ensuring key features underpinning each principle are considered (see checklists).

Five key global guiding principles to consider in developing a Climate Finance taxonomy:

- I. Climate Finance taxonomies should be broadened beyond using use of proceeds to capture entity-level activities and all eligible sources of capital.
- II. Climate Finance taxonomies should be objective in nature, supported by clearly defined metrics and thresholds aligned to the Paris Agreement, and science-based targets.
- III. Climate Finance taxonomies should have a consistent set of principles and definitions, but provide flexibility for regional and temporal variation to align with differences in transition pathways.
- IV. Climate Finance metrics should be defined and applied to sectors using science-based targets, balancing ease of use with transparency and robustness to both assess climate impact and support third-party verification.
- V. Climate Finance taxonomies should be based on a governance process that is robust, inclusive, and transparent, and has the flexibility for continued evolution.

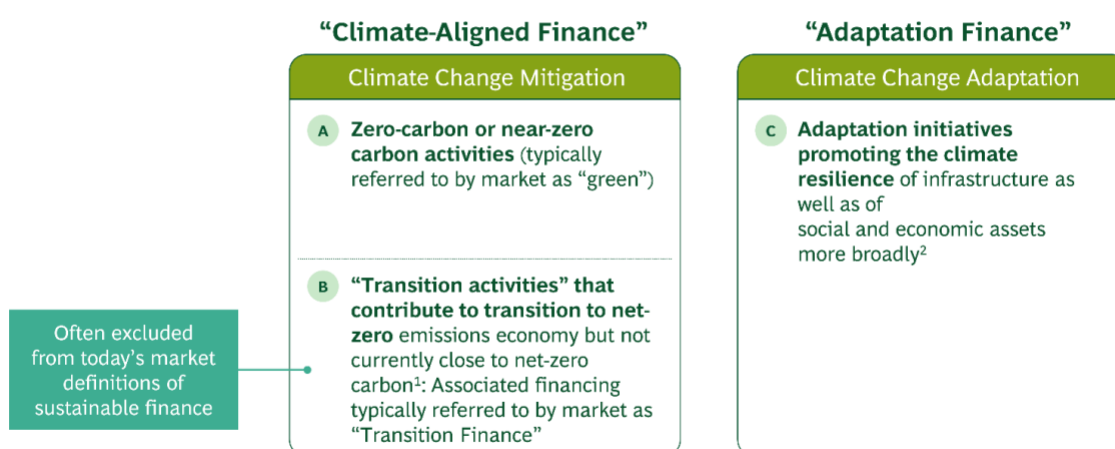
The scope of this paper is limited to Climate Finance taxonomies and does not cover broader environmental, social, and governance (ESG) taxonomies. We acknowledge interdependency between climate change and other environmental objectives (e.g., biodiversity, pollution, water and marine resources, circular economy, etc.), and the impact of climate change policy on society, more broadly. Climate Finance taxonomies should be reassessed and adapted based on future developments in broader ESG taxonomies (e.g., a social taxonomy).

Definition of Climate Finance

The GFMA/BCG 2020 report, *Climate Finance Markets and the Real Economy*, proposed a starting point for defining the topic of Climate Finance and Climate-Aligned Finance: **“Climate Finance is defined as financing that supports the transition to a climate-resilient economy by enabling mitigation actions, especially the reduction of GHG emissions, and adaptation initiatives promoting the climate resilience of infrastructure as well as generally of social and economic assets.”**

Box 1. The five key global guiding principles are aligned to this definition of Climate Finance.

Components of Climate Finance



1. Defined as per definition in EU taxonomy; should show trajectory of performance that aligns with Paris Agreement-aligned transition pathways 2. As per ICMA definitions

I. Climate Finance taxonomies should be broadened beyond use of proceeds to capture entity-level activities and all eligible sources of capital.

Sustainable taxonomy classifications today are primarily focused on single-purpose financing with eligibility established at an activity level (i.e., a use-of-proceeds model). While the use of proceeds model is helpful for financing sustainable activities, **a broader definition of Climate Finance taxonomies capturing the entity-level activities and all eligible sources of capital will be critical to mobilizing equity financing and working capital that is not easily linked to an underlying economic activity.** This is particularly the case for diversified entities that operate across multiple countries, sectors, and sub-sectors.

Derivative markets remain important for managing interest rate risk and price fluctuations (e.g., long-term renewable power purchase agreements). While these hedges do not provide direct financing for decarbonization, they do play a critical enabling role in a corporate's ability to mobilize capital toward the transition in emerging markets. Scaling of equity financing and bank lending will be dependent on the emergence of an entity-level framework that will enable the classification of a group or entity as “transition-aligned” using science-based transition pathways. **Taxonomies should be applicable to a broad suite of financial products—beyond debt instruments, and loans that are based on a use-of-proceeds model—that market participants will need in order to manage a smooth transition.**

External data providers and ratings agencies have a role to play in scaling and standardizing the methodology for entity assessments in Climate Finance. Looking to existing precedent in the market, today, ratings agencies evaluate both specific debt securities as well as the borrowing entities, providing increased market and price transparency, and reducing transaction costs and the operational burden of market participants.

A potential solution for **verifying entity-level eligibility could be resolved under an outcome-based approach.** In turn, agencies and other data providers will need to rely on disclosures to provide transparency on issuers’ entity-level sustainability targets or science-based climate alignment (e.g., percentage of emissions reduced or emission intensity, as a factor of total assets or revenue). **Mandatory disclosures of corporate-specific, financially material, decision-relevant data relating to climate risks and opportunities; standardization of metrics and reporting; and transparency of ratings methodology will be key enablers in implementing entity-level taxonomies.**

To ensure entity-level activities are captured, taxonomies should:

- ☑ Define financial products and instruments that are more suited to an entity-level approach than a use-of-proceeds model
- ☑ Define a framework for standards and methodologies for use by external providers and rating agencies to support entity-level assessments
- ☑ Define metrics and thresholds for entity-level classification informed by national and industry science-based targets
- ☑ Enhance and standardize disclosures to facilitate mapping revenue or assets to different industry sub-sectors and activities
- ☑ Enhance and standardize disclosures to provide transparency and comparability of reporting on the alignment of an entity to national and industry-specific science-based targets

II. Climate Finance taxonomies should be objective in nature, supported by clearly defined metrics and thresholds aligned to the Paris Agreement, and science-based targets.

Beyond agreeing on definitions for the types of activities that qualify as climate-aligned, financial markets need clear metrics and thresholds against which to assess and validate investments.

To truly scale Climate Finance and effectively allocate capital, investors and credit institutions need to be able to easily compare investments across issuers.

External data providers and agencies can accelerate adoption and understanding by incorporating standardized metrics in their ratings methodologies. This proposal is not unlike what exists in the "traditional" debt market wherein security classifications as Investment Grade or Speculative Grade are clearly understood and recognized across issuers and investors alike.

Absent standard metrics and thresholds, transaction costs will remain high due to bespoke review and verification processes, **and investor skepticism of greenwashing will persist.** Disclosure standards will play a critical role in operationalizing definitions and taxonomies. **Formalizing standard metrics into corporate disclosure standards would improve data availability, transparency, comparability, and ease of verification.**

Climate Finance taxonomies are contingent on regional and sector-specific science-based transition pathways that clearly outline the technology paths and interim and final targets. Standard setters should calibrate thresholds to interim targets along the transition pathway, as opposed to focusing only on end-state targets. "Ways of striking the right balance between timeliness, consistency and comparability [of data] will have to be explored, ensuring that the desire for faster progress in some geographies will not be hampered, while at the same time being cognizant of the need for flexibility to account for differences in regional institutional frameworks."⁵ Thresholds for greenhouse gas (GHG) emissions reduction or carbon intensity, for example, should trend toward zero over time across all regions, but **applying too stringent of thresholds today may preclude transition activities from being considered climate-aligned and isolate hard-to-abate sectors from investment.** Thresholds should also be calibrated based on pathways certain regions choose to take instead of being universal for all regions. As regional targets and pathways may differ, the "entry" threshold should reflect the difference. Moreover, as targets and pathways evolve over time, thresholds may change accordingly.

To improve transparency and comparability across investments, taxonomies should:

- ☑ Establish objective metrics that are science-based to reduce subjectivity in eligibility assessments and labelling
- ☑ Calibrate thresholds using science-based targets and phase expectations in line with interim rather than end-state targets to account for differences in transition pathways
- ☑ Enhance disclosure standards to include standardized metrics, thereby improving data availability, transparency, comparability, and ease of third-party verification

⁵ NGFS Progress report on bridging data gaps (May 2021)

To the greatest extent possible, regions should aim for consistency in the metrics used to measure underlying economic activity, but also have flexibility on the setting of thresholds.

III. Climate Finance taxonomies should have a consistent set of principles and definitions, but provide flexibility for regional and temporal variation to align with differences in transition pathways.

It is an important step forward to have global alignment on achieving climate goals through the Paris Agreement, United Nations, and forums such as COP26 in 2021. **Achieving global alignment on a specific goal (e.g., limiting warming to 1.5° Celsius) does not mean each region is following the same transition pathway to get there.**

These differences become particularly pronounced in emerging markets that are expected to transition over a longer period of time. Countries are balancing the need to decarbonize with rapid urbanization and industrialization in their communities. As a result, countries in emerging markets tend to have longer transitions toward net-zero emissions and higher permissible emissions levels in the near term than those in developed markets.

These differences in regional transition pathways flow through to sector and technology expectations. For example, in the steel industry, a key lever in developed markets toward decarbonization is the increased use of recycled scrap and movement away from virgin-steel production. For emerging economies, wherein steel demand far exceeds production, there will need to be less reliance on the recycling of prior materials and more focus on reducing emissions from new production.

Taxonomies can still support standardization by defining key metrics and allowing for regional and temporal variation in threshold levels. **Science-based targets at the regional and/or sector level, rather than overarching global targets, should be used to inform threshold calibration.** This will allow for regional and temporal variation in the application of taxonomies, without compromising global consistency and ease of use by international stakeholders.

To account for regional differences in decarbonization pathways, taxonomies should:

- ☑ Align key metrics and performance indicators to global standards, thereby minimizing measurement differences between regions
- ☑ Define and apply eligibility thresholds at a regional and sector level, as opposed to broad-based global targets, to reflect differences in national policies and prevent exclusion of emerging markets
- ☑ Update and refresh eligibility thresholds periodically to capture changing expectations as countries move forward in decarbonization over time and transition pathways across emerging and developed markets converge

Box 1. Application of the five global guiding principles for Climate Finance taxonomies to a transitioning Asia Market

As referenced, of the \$100–150 trillion in Climate-Aligned Finance needed globally to limit temperature rise to 1.5° Celsius globally, \$66 trillion needs to be invested in Asia alone. The region accounts for around half of the world's carbon emissions and is susceptible to both physical and transition risks. At the same time, economically, Asia is a significantly diverse region whose capital markets are also particularly prone to market fragmentation.¹ Collaboration and coordination to foster consistent regulatory approaches both between the various countries within the Asia region as well as between Asia and other regions, and recognizing Asia's country-specific financing needs will be a significant but important hurdle to overcome through global efforts to raise and direct Climate-Aligned Finance to wherever it is needed most.

Within Asia itself, collaboration, coordination, consistency, and interoperability will be key. To date, a range of taxonomies and taxonomy-like frameworks have been developed in the region, from China's *2015 Green Bond Endorsed Project Catalogue* and Malaysia's *2021 Climate Change and Principle-based Taxonomy* to the work underway by Singapore on its taxonomy, in addition to private-sector taxonomies. Japan also published *Transition Finance Guidelines* in May 2021. Public-sector efforts to date range from granular to more principle-based approaches. Collaboration and coordination efforts within the region will require the development of taxonomies that account for both internationally agreed upon climate goals as well as the diverse set of Association of Southeast Asian Nations (ASEAN) region's climate targets. Among these efforts, there must be clear and consistent definitions for activities qualifying as climate-aligned along with science-based targets, in line with **Principle II**, in order to maintain confidence among international investors investing in Asian markets.

There is also expected to be a significant dependency on bank-intermediated lending in ASEAN and other Asian markets, reflecting the limited maturity of certain capital markets in the region. In line with **Principle I**, a broader definition of Climate Finance will be critical to mobilizing capital not easily linked to one specific underlying economic activity. The scaling of bank lending will be dependent on the emergence of entity-level taxonomies to enable classification of a group or entity as transition-aligned.

Recognition of different threshold targets, as well as pathways tailored for emerging economies, will be important in Asia. A number of Asian economies are today heavily coal dependent, with power generation, iron and steel manufacturing, buildings, and transportation all requiring significant investment to support decarbonization objectives. Governments have the challenge of balancing improvement in environmental standards with economic growth to support industrialization and urbanization, and advance the living standards of rapidly growing populations. Emerging markets in Asia will therefore have a different transition pathway to curbing emissions from developed nations, and applying too stringent a threshold in these markets may inhibit or delay overall design, and investment in, transition pathways. For example, a legitimate transition pathway for these economies today may include the use of abated natural gas as an interim replacement for coal while they scale renewable-energy capacity for future use. In line with **Principle III**, taxonomies in Asia should still support standard key metrics but allow for regional and temporal variation in threshold levels, as well as some nuances in preferred pathways.

Role of development banks will be important in Asia. Investment risks with the potential to limit the scale of the Climate Finance mobilized in Asia includes sub-scale projects and sovereignty, currency, and political factors in emerging markets. Governments and national/multilateral development banks should motivate the mobilization of private sector capital through the introduction of credit support mechanisms within blended public/private finance solutions. In addition, development banks themselves have an important role to play in the development of both sector- and region-specific taxonomies through coordinated design and implementation.

IV. Climate Finance metrics should be defined and applied to sectors using science-based targets, balancing ease of use with transparency and robustness to both assess climate impact and support third-party verification.

Climate Finance taxonomies will be critical to both defining transaction eligibility criteria for being considered climate-aligned and the subsequent verification and attestation processes. Having consistent science-based measurement standards implemented by third-party verifiers (which could include independent auditors, regulated official sector or industry bodies, or others) and ratings agencies will only improve transparency into, and comparability across, climate-aligned investments and develop trust and confidence in issuers' carbon-reduction business-plan forecasts.

However, implementation of any new framework or taxonomy comes with changes to existing business and reporting processes. Many corporates and financial institutions today are already under heightened reporting pressures—which are magnified for international companies managing different regulatory and oversight regimes. **To promote adoption across markets, taxonomies need to consider ease of use and impact to corporate reporting processes.**

Limiting scope to a specific set of core indicators, as opposed to multiple metrics, can help minimize implementation costs. For example, single metrics such as “carbon intensity” can provide sufficient clarity for third parties on whether a particular technology or project is aligned to climate goals. With clear guidance on what data is needed to support verification, private sector participants can better focus their resources and efforts.

Ensure safeguards, such as Do No Significant Harm (DNSH) provisions for other environmental goals, do not function as unnecessary impediments for recognition of Climate Finance alignment. Wherever safeguards are introduced, we recommend basing any verification requirements on existing data, rather than the creation of additional new data sets for Climate Finance alignment verification. As another consideration, using compliance with existing local legislation may facilitate verification for companies or investments in that jurisdiction, but also may create additional hurdles for verifying compliance for companies or investments outside of that jurisdiction. As a final point, safeguard measures should not be overly punitive, which would risk unnecessarily reducing Climate-Aligned Finance activities' eligibility versus the application of safeguards for economic activities with high GHG intensity.

Standard setters and third-party verification bodies should also be transparent in how they apply the taxonomy principles to their requirements. Increased clarity from verifiers on who is attesting to the accuracy and sources of issuers' carbon reduction business plan forecasts, how their ratings are actually

To ensure taxonomy application is science-based and practical, while also supporting robust third-party verification, taxonomies should:

- ☑ Focus reporting and eligibility criteria as defined in taxonomies on a limited, non-exhaustive set of metrics
- ☑ Align mandatory and voluntary disclosure and reporting standards to the key metrics defined for a given sector or technology
- ☑ Improve transparency into third-party verification standards, data requirements, and methodologies

developed, and what data is required will allow corporates and private sector participants to align their reporting processes and standardize reporting to the greatest extent possible.

V. Climate Finance taxonomies should be based on a governance process that is robust, inclusive, and transparent, and has the flexibility for continued evolution.

A robust governance process is a necessary foundation for creating a Climate Finance taxonomy that is useful to market participants.

The development of a Climate Finance taxonomy should begin with a scoping exercise to determine the objective as well as the intended users of the taxonomy. Any Climate Finance standards must be oriented around a clearly defined understanding of the goals of a Climate Finance taxonomy, including how market participants will use it in practice.

To ensure that a Climate Finance taxonomy is useful to market participants, it should be developed using inputs from appropriate stakeholders, including the intended users and the entities that will be assessing taxonomy alignment, in addition to relevant technical experts.

One of the most important hurdles to the development of Climate Finance taxonomies is data availability and quality. A

robust governance process is needed to ensure that potential issues with data availability and quality are identified and addressed during the taxonomy development process. Involvement of appropriate stakeholders helps surface considerations around linkages to corporate disclosure. As noted, disclosure standards will play a critical role in operationalizing definitions and taxonomies.

Recognizing that Climate Finance taxonomies will continue to evolve over time, an effective governance mechanism should allow for ongoing evolution of a taxonomy such that standards do not become outdated.

To ensure taxonomies are based on a robust, inclusive, and transparent governance process, the taxonomy development process should:

- ☑ Clearly outline the scope, objective, use case, and intended users of the taxonomy
- ☑ Build a robust process with inputs from appropriate stakeholders, including the intended users, the entities that will be assessing taxonomy alignment, and relevant technical experts
- ☑ Create flexibility for ongoing evolution such that standards do not become outdated

2. Addressing Transition Finance in Taxonomies

Transition activities are defined as activities that contribute to the transition to a net-zero emissions economy by 2050, but do not currently bring the transition close to a net-zero carbon emissions level; whereas enabling activities are defined as activities that enable improvement of environmental performance to a fairly demanding level in other sectors of the economy.

Article 6(1a) of the EU Taxonomy outlines the framework for evaluating transition activities through the lens of “substantial contribution to climate change mitigation⁶.” In order for an activity to be taxonomy compliant, it must significantly enhance GHG emission performance beyond industry average, should not hamper the development of low-carbon alternatives, and should not lead to or lock in carbon-intensive assets or processes. **The transition finance activities that do not meet the taxonomy Screening Criteria (SC) may still reduce harm to environmental objectives, but would not, in reference to the Taxonomy, be considered sustainable.**⁷

This definition and stringent SC for transition and enabling activities may lead to the exclusion of activities that are aligned to national and sector-specific science-based transition (SBT) pathways but are not low or zero carbon. **This will result in unavailability of capital or a higher cost of funding for transition and enabling activities that are aligned to SBT pathways and can make meaningful contributions to decarbonization.** Exclusion of transition and enabling activities will result in a “wait and see” approach in the real economy—and more specifically, in the hard-to-abate sectors. Corporates may also defer investment decisions until there is significant advancement in underlying technology for an activity to meet the stringent standards of SC.

Use-of-proceeds structures inherently are limited in their effectiveness in measuring carbon reduction, since criteria must be focused in point-in-time projects/assets that are included in the bond/loan offering, rather than an ongoing business. **To address the challenges of existing taxonomies, several industry-level and firm-level private sector initiatives have proposed a broader definition and more granular classification of transition-aligned activities.** As an example, the Climate Bond Initiative (CBI) proposed five categories of activities (Near Zero, Pathway to Zero, No Pathway to Zero, Interim, and Stranded) and that a new “Transition” label be assigned to activities that are classified as Pathway to Zero and Interim. **This would ensure that activities that do not meet the SC of national taxonomies but are aligned to SBT pathways will be eligible for financing as climate-aligned activities.** This concept could be expanded beyond bonds to facilitate all financing models (e.g., project finance, green equity).

⁶ https://unfccc.int/files/meetings/paris_nov_2015/application/pdf/paris_agreement_english_.pdf

⁷ Taxonomy: Final Report of the Technical Expert Group on Sustainable Finance (March 2020).

Activities that are not aligned to SBT pathways will be ineligible for classification as Climate-Aligned Financing. CBI classifies these activities as Stranded, defined as activities that cannot be brought in line with global warming targets and have an alternative, low-emissions substitute (e.g., electricity generation from coal). By definition, activities that are not explicitly covered within the scope of the climate-aligned taxonomies are either not relevant for decarbonization or not aligned to national and sector-specific SBT pathways.

Climate Finance taxonomies should not be limited to activity-level guidance and should also cover entity- and portfolio-level guidance. As highlighted in the EU Transition Finance Report (March 2021), the term “transition” is widely used in reference to the economy, sectors, financial portfolios, and companies. However, the EU taxonomy and other taxonomies are focused on individual activities and do not cover companies, portfolios, and sectors. **To support the inclusion of entity- and portfolio-level transactions, climate-finance taxonomies should also provide clear guidelines on classification based on the alignment of the company (or group of companies) to SBT pathways.** This can be achieved by mapping the activities of an entity, based on revenue, assets, or value, to different regions, sectors, and sub-sectors, and assessing the alignment of the activities to SBT pathways for that specific region, sector, and sub-sector. In addition to a point-in-time alignment, the entity will also be assessed based on its decarbonization roadmap, external commitments, and metric reporting to track the commitments.

Currently, climate-related entity-level disclosures are voluntary in most jurisdictions and not subject to independent audit or verification. **Assessments disclosed by companies should be based on industry standards reinforced by a strong control framework and subject to independent audit.** A mandatory disclosure should focus on corporate-specific financially material, decision-relevant data relating to climate risks and opportunities. Consistent global disclosure frameworks, developed in consultation with industry participants and with adequate runway for implementation, should help strengthen the transparency and comparability of climate risk data.⁸ Climate Finance taxonomies should propose a classification system for companies or groups of companies—for example, Not Aligned to SBT pathways, Partially Aligned (if less than 50 percent of activities are aligned), Fully Aligned (if more than 75 percent of activities are aligned), or Net Zero. Entity classification will be important for mobilization of capital that is not associated with a specific activity but is critical to the overall transition readiness of the real economy.

Climate Finance taxonomies should be supported by a robust verification and attestation framework to mitigate the risk of green- or transition-washing. Climate-finance taxonomies can be supported by four forms of verification: disclosure and self-certification by corporates and issuers; independent audit of disclosures; specialist second-party opinions; or external rating agencies. This is essential to developing trust in issuers’ carbon reduction business plans, and to enable readers of various business plans to compare the metrics used to measure the science-based corroboration of business plan forecasts. Private sector taxonomies by banks and asset managers (e.g., Sustainable Finance Framework) are often supported by second-party opinion to ensure alignment of the framework to industry guidelines, leading practices, and national taxonomies. In addition to private sector taxonomies, the issuance of public

⁸ IFRS, IOSCO, FSB TCFD, etc.

securities based on a use-of-proceeds model (e.g., green bonds) is also subject to pre-issuance review and post-issuance verification of fund allocations.

At an entity level, several external rating agencies provide an ESG rating (including but not limited to climate risk) for an enterprise based on public or private data (e.g., questionnaires). The methodology (factors, weighting, and expert judgment) used by external providers may not be transparent, thus the market does not have a clear understanding of why ratings across different providers can exhibit low correlation for the same entity (i.e., the same firm can have divergent ratings by different rating providers). **The current lack of transparency in entity ESG ratings (e.g., Why would two different providers' ratings diverge?), is an impediment for the efficient allocation of capital and the necessary scaling of Climate Finance markets.**

Climate Finance taxonomies should not be limited to the scaling of proven and economically viable technologies and activities (e.g., renewables); they should also enable the mobilization of capital for innovation and research and development (R&D) of alternative solutions. The 2020 GFMA/BCG report noted a mismatch between the risk profile of the capital available (low risk) and capital required (high risk). Climate Finance taxonomies should be designed with a specific focus on mobilizing equity capital to bridge the investment gap. And the taxonomy should be updated periodically to reflect the changing landscape of decarbonization solutions and technology innovation.

The role of equity eligibility is important, as equity and other sources of patient capital are often needed to fund longer-term investment in R&D in low-GHG technologies and provide sufficient levels of loss absorbency to support the raising of debt finance. The use-of-proceeds model currently used does not facilitate such equity exposure being recognized as Climate Finance due to the nature of the equity being issued at the parent level, and not necessarily being tied to particular projects in the same way debt finance can be.

3. Conclusion

The global economy must fundamentally transform in order to achieve the ambitions set out to further the Paris Agreement and other emerging international commitments. This transformation will require coordination across all sectors and regions, as well as considerable investment, estimated at \$100–150 trillion by 2050. Climate-Aligned Financing will need to scale exponentially to support investments across all regions and sectors of the global economy. The taxonomies and financing must go beyond the use-of-proceeds model, to include a broader set of investments that account for entity-level activities and a broad range of financial instruments. Taxonomies will be essential for determining whether investments in these activities are aligned with climate goals. However, due to regional and sectoral nuances, pathways to transition will be different across jurisdictions and industries. For this reason, a single global taxonomy is unlikely to be viable; however, global principles can be applied across all jurisdictions and industries to ensure activities are aligned with Paris goals. These taxonomies must be objective and rely on science-based metrics and targets to guarantee this alignment. Additionally, as this is a dynamic field, the governance of these taxonomies must allow for flexibility as pathways, industries, and technologies evolve. The principles set out in this paper address each of these needs, as well as identify the requirements and considerations needed to develop the comparable taxonomies essential for supporting a climate-aligned transition.

4. Appendix: Summary of Principles

1. Climate Finance taxonomies should be broadened beyond use of proceeds to capture entity-level activities and all eligible sources of capital

- 1.1 Define financial products and instruments that are more suited to an entity-level approach than a use-of-proceeds model
- 1.2 Define a framework for standards and methodologies for use by external providers and rating agencies to support entity-level assessments
- 1.3 Define metrics and thresholds for entity-level classification informed by national and industry science-based targets
- 1.4 Enhance and standardize disclosures to facilitate mapping revenue or assets to different industry sub-sectors and activities
- 1.5 Enhance and standardize disclosures to provide transparency and comparability of reporting on the alignment of an entity to national and industry-specific science-based targets

2. Climate Finance taxonomies should be objective in nature, supported by clearly defined metrics and thresholds aligned to the Paris Agreement, and science-based targets

- 2.1 Establish objective metrics that are science-based to reduce subjectivity in eligibility assessments and labelling
- 2.2 Calibrate thresholds using science-based targets and phase expectations in line with interim rather than end-state targets to account for differences in transition pathways
- 2.3 Enhance disclosure standards to include standardized metrics, thereby improving data availability, transparency, comparability, and ease of third-party verification

3. Climate Finance taxonomies should have a consistent set of principles and definitions, but provide flexibility for regional and temporal variation to align with differences in transition pathways

- 3.1 Align key metrics and performance indicators to global standards, thereby minimizing measurement differences between regions
- 3.2 Define and apply eligibility thresholds at a regional and sector level, as opposed to broad-based global targets, to reflect differences in national policies and prevent exclusion of emerging markets
- 3.3 Update and refresh eligibility thresholds periodically to capture changing expectations as countries move forward in decarbonization over time and transition pathways across emerging and developed markets converge

4. Climate Finance metrics should be defined and applied to sectors using science-based targets, balancing ease of use with transparency and robustness to both assess climate impact and support third-party verification

- 4.1 Focus reporting and eligibility criteria as defined in taxonomies on a limited, non-exhaustive set of metrics
- 4.2 Align mandatory and voluntary disclosure and reporting standards to the key metrics defined for a given sector or technology
- 4.3 Improve transparency into third-party verification standards, data requirements, and methodologies

5. Climate Finance taxonomies should be based on a governance process that is robust, inclusive, and transparent, and has the flexibility for continued evolution

- 5.1 Clearly outline the scope, objective, use case, and intended users of the taxonomy
- 5.2 Build a robust process with inputs from appropriate stakeholders, including the intended users, the entities that will be assessing taxonomy alignment, and relevant technical experts
- 5.3 Create flexibility for ongoing evolution such that standards do not become outdated

Global Guiding Principles for Developing Climate Finance Taxonomies

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