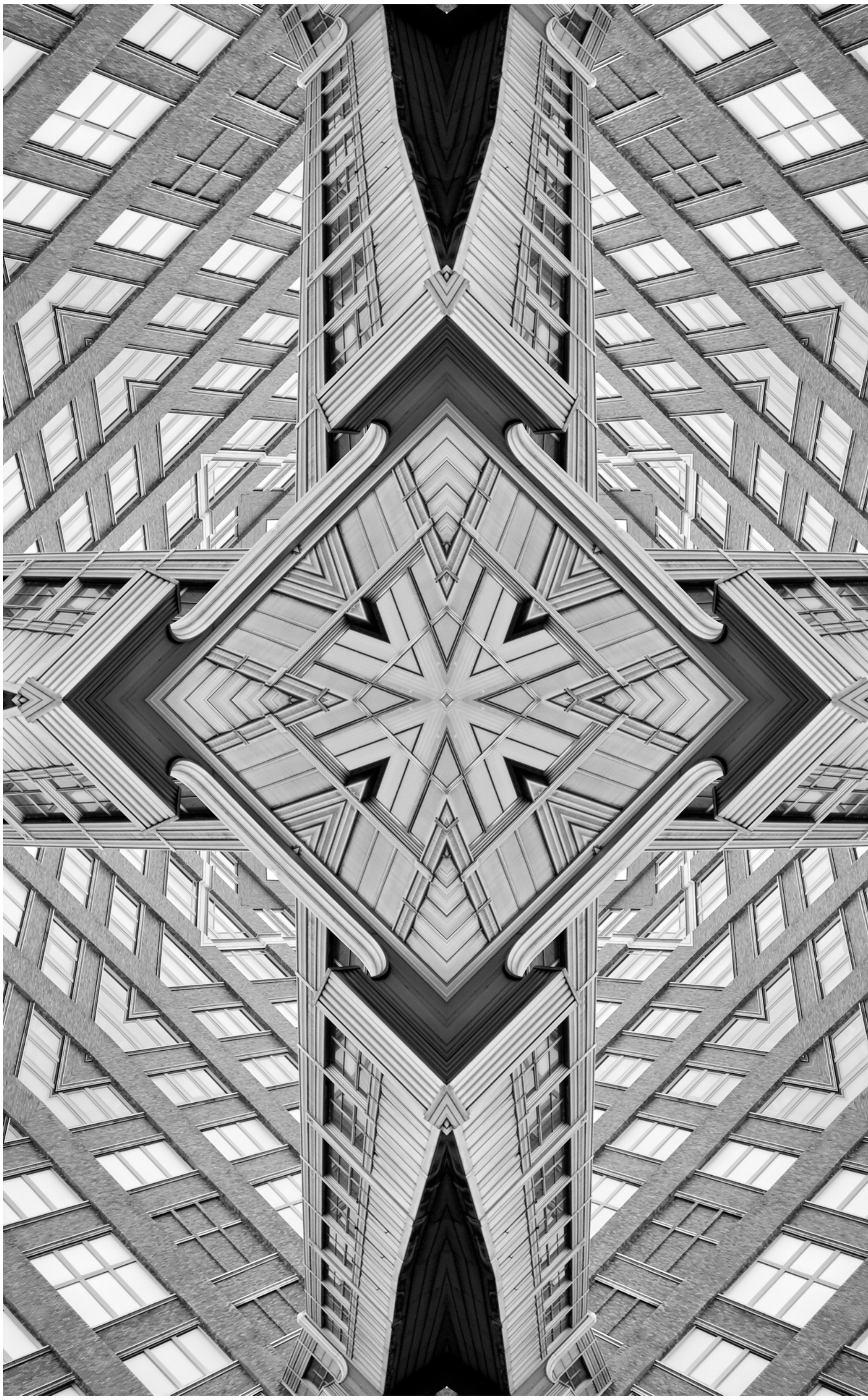
Issue Brief

ISSUE NO. 778
FEBRUARY 2025



Creating Effective Sustainable Finance Taxonomies

Labanya Prakash Jena and Gauri Tandon

Abstract

A number of countries, including India, have either announced or are already implementing sustainable finance taxonomies that help mobilise capital for sustainable development and climate action. This brief examines the challenges to implementing sustainable finance taxonomies, including lack of harmonisation and standardisation, unavailability of data, lack of capacity, and financial burdens on companies applying these taxonomies. The brief proposes strategies to address these challenges, outlining lessons that can be learned from case studies that illustrate the practical aspects of taxonomy implementation.

Attribution: Labanya Prakash Jena and Gauri Tandon, "Creating Effective Sustainable Finance Taxonomies," *ORF Issue Brief No. 778*, February 2025, Observer Research Foundation.

The Context

Institutions and governments worldwide recognise the importance of a low-carbon and climate-resilient economy—and the role of sustainable finance in achieving that goal. Yet, there is no universal definition of what constitutes 'sustainable finance', to begin with. This lack of clarity prevents governments from tracking capital flows to "sustainable" sectors and assessing whether enough capital is flowing to the targeted sectors to meet countries' Nationally Determined Contributions (NDC) targets. The absence of a universally accepted definition of "sustainable" sectors and economic activities also creates uncertainty in identifying sustainable businesses among players in the financial sector, consequently hindering capital flows to these businesses. Moreover, the lack of a definition prevents regulators and policymakers from framing appropriate policy and regulatory measures for sustainable businesses and climate solutions.

Sustainable finance taxonomies have gained widespread interest and mark a milestone in global efforts to integrate environmental and sustainability considerations into the financial system. As of April 2024, 47 sustainable finance taxonomies have been created in different parts of the globe.[1] Some of the countries that have developed, or are in the process of developing sustainable finance taxonomies, are India, the United Kingdom, China, Canada, and certain economies in Europe. In these countries, national governments are leading in the development of sustainable finance taxonomies. Existing taxonomies highlight countries' commitment to advancing sustainable actions, including climate-related measures, and enhancing capital flows for sustainable businesses. However, this interest also raises questions about the practical challenges of implementing such a framework.

Implementing a sustainable finance taxonomy requires a comprehensive understanding of its operational complexities as the policy framework moves from announcement to execution. Aligning the taxonomy with countries' existing financial regulations, ensuring that it remains adaptable to the evolving nature of sustainable technologies, and harmonising it with international standards—all while considering countries' unique socio-economic environments—demand thorough analysis and strategic planning.

These challenges demand a further examination of how financial institutions, investors, and businesses will operationalise a sustainable finance taxonomy. Potential barriers include limited capacity-building efforts to familiarise stakeholders with the taxonomy, lack of clarity in defining "sustainable finance", and the need for mechanisms necessary to prevent greenwashing.

The Context

Therefore, the announcement and implementation of sustainable finance taxonomies has helped advance the global sustainability and climate agenda. It has also served as a starting point for deeper conversations about the practicalities of implementation to ensure that the taxonomies deliver on their promise of facilitating transitions to sustainable, low-carbon economies.

The Definition and Significance of Sustainable Finance Taxonomies

In the context of sustainable finance, a taxonomy is a classification system that identifies the activities, assets, and project categories that deliver on key climate, green, social, and sustainable objectives.[2] According to the UN Environment Programme Inquiry, 'sustainable finance' is a broader terminology, whereas 'green finance' is a subset. 'Climate finance', meanwhile, is a subset of green finance and includes climate mitigation and adaptation finance. This brief uses the term "sustainable finance taxonomy", although there are various others being used by policymakers and regulators, such as "climate finance taxonomy" and "green finance taxonomy."

A sustainable finance taxonomy can accelerate capital flows to achieve listed objectives through different approaches. It allows governments to track capital flows into "sustainable" sectors and assess whether there are enough capital flows to the targeted sectors to meet countries' sustainable development and climate goals. A taxonomy also helps reduce ambiguity around sustainable businesses among players in the financial sector, which would otherwise hinder capital flows to these businesses. The taxonomy can guide investors and companies in identifying sustainable technologies and solutions and enhancing decision-making for sustainable business and financial practices. It can reduce the risks of greenwashing and improve the integrity and efficiency of the sustainable financial market, enabling investors to fund projects that comply with regulations and facilitate a low-carbon transition and sustainable development. While nearly 75 percent of advanced economies have a national or regional taxonomy, only about 10 percent of emerging and developing economies have such coverage, potentially hindering the latter's ability to attract capital for sustainable businesses and climate solutions.[3] Implementing a sustainable finance taxonomy is not easy.

One challenge is posed by the need for regulatory integration, as sustainable finance taxonomies must align with existing legal frameworks. The complexity of creating a universally accepted taxonomy is another hurdle, given different countries' diverse economic and environmental contexts. Additionally, the lack of harmonisation and standardisation among existing taxonomies creates inconsistencies that can confuse market participants and impede cross-border investments. Data availability, crucial for assessing sustainability, also remains an issue. There is a lack of the necessary infrastructure and incentives for collecting and reporting accurate sustainability and climate-related data, leading to gaps, which undermine the climate actions of policymakers. Direct and indirect financial burdens also hinder the implementation of sustainable finance taxonomies. The costs associated with developing, maintaining, and complying with these taxonomies can be substantial, particularly for smaller banks and non-banking financial companies.

To address these challenges, there is a need for strategies such as promoting international cooperation for regulatory harmonisation, simplifying taxonomy frameworks to enhance understanding and compliance, investing in data-collection infrastructure, and providing financial support for entities that bear the brunt of implementation costs.

Regulatory Integration and Ambiguities

Many of the challenges to the implementation of taxonomies arise from a lack of regulatory integration. For instance, the taxonomy in South Africa is not integrated with the country's sustainability and climate change policies.[4] The limited participation of regulatory actors in developing the sustainable finance taxonomy, the absence of mandatory disclosure requirements according to the taxonomy, and the parallel actions on "just transition", which is very similar to the taxonomy, hinder the acceptability of the taxonomy.

Lack of Leadership

In some instances, the top government body does not offer adequate support or provide the necessary leadership[5] to effectively implement the taxonomy. Poor communication from leadership fails to motivate stakeholders, leading to complacency.

Lack of Harmonisation and Standardisation

National taxonomies enable policymakers to create frameworks that reflect local contexts and align with specific environmental goals and national commitments. This localisation fosters ownership and maximises usability within domestic markets. However, the diversity of these taxonomies raises concerns about market fragmentation.[6] The lack of a universal standard presents challenges for market participants outside the domestic market.

While these taxonomies reduce market friction at the national level, they can cause friction internationally. Inconsistencies in definitions and standards can obscure investor operations in cross-border activities, complicate operations across jurisdictions, and hinder efforts to prevent greenwashing. The Sustainable Banking and Finance Network (SBFN) Toolkit[7] shows that, while all countries with taxonomies include climate change mitigation, most also identify other green objectives like climate change adaptation, pollution prevention, circular economy, water resource protection, and biodiversity. Additionally, many countries support social goals, the blue economy, and the Sustainable Development Goals (SDGs).

Challenges to Implementing Sustainable Finance Taxonomies

Taxonomies range in complexity from high-level, principles-based approaches to detailed catalogues with strict technical criteria, metrics, and environmental and social safeguards.[8] This diversity risks proliferating different definitions, fragmenting approaches, and increasing transaction costs, particularly for cross-border investments. These risks are intensifying as taxonomies become integrated into national financial regulations.

The existence of parallel classification systems for sustainable actions further complicates the landscape. For instance, South Africa's climate budget-tagging system for public-sector entities, currently in its pilot phase, adds another layer of classification that may conflict with the main taxonomy.[9] This raises doubts about whether a single taxonomy can serve as a common language in financial markets.

Voluntary vs. Mandatory Approaches

Countries that have developed sustainable finance taxonomies have chosen a voluntary approach for their implementation. This approach poses challenges to assessing and disclosing taxonomy alignment among users and implementing agencies if most market participants do not participate. The interrelated nature of financial markets necessitates data from all participants, which is often unavailable in a voluntary framework.

Complexity and Technical Difficulties

Taxonomies are often perceived as complex documents that require expertise to understand and interpret, as well as time to apply. Ensuring that economic activities meet the "Do No Significant Harm" criterion in the taxonomy poses a particular challenge for users.[10] The complexity increases with the length of investment chains and the involvement of multiple parties in data collection, making taxonomy assessments burdensome.

Capacity Constraints

Another challenge to implementing a taxonomy is corporate and institutional lack of capacity. Adopting a taxonomy requires specific expertise to understand its nuances, which is essential to implementing it adequately for the benefit of users. These entities, particularly in developing countries, do not have specialised team members who understand the taxonomy to implement it and to assess whether it is properly aligned with their sustainable development or green goals.

Financial Costs

The financial costs associated with implementing and complying with taxonomies can be high. These include expenses related to data collection, reporting, and verification processes. Smaller market participants may find these costs prohibitive, hindering widespread adoption and effective implementation. In addition, there could be additional costs if a third party needs to verify the disclosure report. Although third-party verification increases a report's credibility, it also raises costs for implementing agencies, particularly small and medium companies.

Difficulty in Acquiring Data

Banks and financial institutions rely on their borrowers and investee companies to provide accurate data on the use of financing and how it aligns with the taxonomy. If borrowers and investee companies do not provide adequate data, particularly when it is voluntary, banks and financial institutions find it challenging to disclose how their finances align with the taxonomy. This issue becomes more problematic when financing is channelled to corporations for general purposes, such as through corporate loans, equity, or credit lines, where the use of finance is not specified in detail, unlike in the case of project financing.

Another challenge is the difficulty in sourcing information for reporting purposes. The required information is not always directly available and needs to be determined through additional information generated within the company or requested through manual processes. This process can be time-consuming and may introduce uncertainties in reporting.

Compliance Challenges

The complexity of interpreting the concepts and criteria of the taxonomy hinders implementation. Furthermore, regulatory documents are open to interpretation, which can give rise to challenges arising from the interpretation of regulatory requirements, such as varying approaches and discrepancies in reporting practices across organisations.

Additionally, the timeframe between the publication of regulatory guidelines on the taxonomy and its implementation is short, which leaves organisations with little time to adequately comply with the taxonomy. As sustainable taxonomies evolve, organisations find it challenging to consistently meet compliance within such short timeframes. They need to set up suitable processes, source information, and interpret regulatory requirements quickly to identify, assess, and report on the alignment of their economic activities with the taxonomy. The absence of a help desk to assist organisations in clarifying and interpreting these concepts is another challenge.

Issues with Data Availability

The effective implementation of a taxonomy relies on the availability of relevant data. Market participants need access to comprehensive and accurate data to assess and disclose their taxonomy alignment. Data on environmental objectives, such as pollution, water and biodiversity protection, and waste and recycling, is often unavailable. This data gap poses a challenge for corporations and investors aiming to meet taxonomy criteria.

In addition, there are problems with the quality of the available data to assess whether it is aligned with the Technical Screening Criteria (TSC) of the taxonomy. Quality data is mostly not publicly available, which makes it difficult for organisations to prove that the taxonomy meets the TSC. In many instances, technical interpretation can be complex and requires experts to assess alignment.

In addition, there is a lack of consistency and comparability of data. Corporations can use data points that suit them, but the data do not help users analyse the taxonomy meaningfully.

Recommendations

Enhancing Policy and Regulation

A cohesive strategy from the highest governing authority (e.g., the Ministry of Finance) is crucial as it would enable regulatory agencies to enforce jurisdictional and regulatory requirements. Regulatory bodies must integrate the taxonomy into existing regulations and standards to prevent redundancy and avoid parallel initiatives that do not align with the taxonomy. To achieve this goal, governments must prioritise the incorporation of taxonomies into national policies and development plans.[11]

Government Leadership

The current underutilisation of taxonomies underscores the need for authoritative signals and directives from the top levels of government. Strong and decisive leadership, particularly from key entities such as the Ministry of Finance, is essential. Clear instructions from the topmost levels to incorporate taxonomies in policies and processes can give impetus and push stakeholders to accept and adapt to the taxonomies. Leadership engagement can expedite climate-centric agendas, while governmental enforcement mechanisms will solidify institutional adoption.[12]

A Roadmap for Taxonomy Adoption

Detailed guidelines on operationalising the taxonomy can help organisations implement a taxonomy effectively. Regulatory bodies can push regulated entities to adopt a taxonomy. A clear roadmap and an operational document for regulatory bodies can help them adopt a taxonomy that aligns with their mandate and does not conflict with their existing policies and regulations.

Coordination and Communication

Effective coordination among stakeholders is paramount. Establishing mechanisms like a Taxonomy Oversight Committee (TOC)[13] can facilitate cohesive implementation and ensure coordination among public authorities. These mechanisms can share progress updates, which are imperative to upholding transparency among stakeholders. Defining responsibilities and promoting strong coordination among relevant institutions will also aid the acceptability and adaptability of the taxonomy. Additionally, outreach initiatives tailored to diverse actors and users will ensure inclusivity throughout the taxonomy's lifecycle.

Recommendations

Facilitating Clarity and Accessibility

Establishing a point of contact[14] or formalised process that can compile and respond to questions of interpretation is crucial. Providing comprehensive application guidelines and accessible online tools is imperative to clarify definitions and terms in a binding manner. The taxonomy should specify parties responsible for classification, whether corporations self-declare, or banks make judgements in the process of ensuring due diligence. The design should clarify whether classification is at the business group, entity, project, or activity level.

Difficulties faced by banks and financial institutions in acquiring and verifying data necessitate clear guidance and proactive signals from regulatory authorities. Issuing comprehensive guidance notes[15] can drive the adoption of taxonomies, and issuing proactive guidance notes can boost adoption by offering actionable insights and practical advice. Non-binding guidance notes play a key role in simplifying reporting processes across sectors. These measures collectively create a unified and effective regulatory environment.

Capacity Building

Ensuring comprehensive capacity building through appropriate education and training is critical. Utilising the expertise of multilateral institutions and specialists in taxonomy implementation can help build capacity among organisations to better understand the nuances of taxonomy. User-friendly guidelines and training for market participants can help better navigate taxonomies. Pilot programmes[16] and case studies offer practical insights and build capacity for effective implementation.

Harmonisation and Standardisation

Promoting harmonisation and standardisation is key. International forums facilitate knowledge exchange and harmonisation efforts. Establishing international compatibility[17] of the taxonomy and promoting globally comprehensive sustainability reporting is also recommended.

Existing finance taxonomies from other countries can serve as starting points for nations that are new to taxonomy development, aiding global harmonisation efforts. These frameworks, tailored to similar stages of development or strategic

Recommendations

goals, offer foundational principles that can be adapted to local contexts. Harmonisation strategies might initially involve adopting basic principles and criteria, such as Do No Significant Harm (DNSH), then adjusting them to fit national laws and circumstances. This approach encourages the adoption of comparable objectives and classification systems across jurisdictions,[18] promoting transparency and reducing the complexity of sustainable investments.

Specifying internationally recognised equivalents for European Union (EU) regulatory and standard compliance criteria facilitates alignment with global practices.[19] This specification would also support smoother integration and mutual recognition in international markets.

Data Availability

Improving data availability and quality is imperative. Establishing robust data-collection and reporting systems aligned with international standards can help address data availability challenges. The EU taxonomy can be used as a standard to advocate for a European Single Access Point (ESAP).[20]

Data quality can be enhanced by encouraging corporate disclosures through regulatory reforms. Regulating data providers to enforce minimum standards[21] is essential to ensure reliable data generation. Regular reviews of references are also necessary to maintain accuracy and relevance, improving data quality over time. Timely amendments can enhance process reliability and ensure alignment with evolving standards.

Mitigating Financial Burdens

Since compliance requires significant resources, reducing financial burdens is crucial for encouraging wider adoption of the taxonomy. Financial incentives and support for companies, particularly Micro, Small and Medium Enterprises (MSMEs), to comply with taxonomy requirements can mitigate financial burdens. Additionally, cost-effective certification services encourage adoption.

Mandatory Disclosure

Alignment with the taxonomy for disclosure and reporting is key to implementing the taxonomy across systems and in the investment value chain. The EU and China have adopted mandatory reporting requirements for taxonomy compliance.[22] In the EU, large investing companies must disclose compliance with the taxonomy, and in China, the Green Industry Guiding Catalogue is mandatory for sustainable financing activities.[23] Mandatory reporting ensures standardisation and consistency, promoting broader sustainable investment and driving significant changes in investment patterns.

Enforcement of Documentation Standards

Establishing rigorous documentation standards for banks during taxonomy alignment reviews with borrowers ensures thoroughness and reliability and promotes accountability and transparency in the implementation of sustainable finance taxonomies.

Establishing a verification and certification system is crucial for enhancing consistency and credibility in sustainable finance initiatives. South Africa has introduced a certification system for Green Finance taxonomy reports that mandates independent verification.[24] Drawing from EU directives, such a system would mitigate greenwashing risks associated with green bonds or loans, thereby fostering market growth. Developing certification and verification systems can reduce greenwashing risks and enhance credibility.

Conclusion

The successful implementation of sustainable finance taxonomies requires addressing regulatory integration, simplifying complexities, promoting harmonisation, improving data availability, and reducing financial burdens. There is a need for clear guidance, stakeholder coordination, and international cooperation. Proactive and collaborative measures can drive effective taxonomy implementation and promote sustainable economic activities.

Regulatory authorities should define responsibilities and ensure coordination among institutions. Implementing verification and certification systems can enhance credibility. Market participants should engage in training and capacity-building programmes to understand and apply taxonomies effectively.

Governments and regulatory bodies should prioritise transparency and communication to build trust in the taxonomy. Clear guidelines and support for companies and financial institutions will also facilitate adoption. Additionally, international cooperation is crucial for harmonising taxonomies and achieving interoperability.

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