



TAXONOMIES IN ESG FINANCE:

international lessons
and pathways for Brazil



EXECUTIVE SUMMARY



Study developed by Association Sustainable Inclusive Solutions, within the project “Financial sector monitoring, support for the development of Green Taxonomy and integration of climate risks into financial regulation”, supported by Instituto Clima e Sociedade (iCS)

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Introduction

The elaboration of Green, Social or Sustainable Taxonomies is a powerful tool for the diagnosis of the sustainability of economic activities that can be used for multiple purposes. It enables the evaluation of the sustainability of loans and investments portfolios, enables financial institutions to identify activities to which they want to direct more or less capital, and also allows companies to have clarity about the direction to develop their business strategy in order to have more access to capital or other benefits that might be established through public policies (tax incentives, for example). It also allows the creation of synergies and economies of scale for technologies that bring effective environmental and social benefits, and increase the chances that our societies are able to face the socio-environmental challenges of our time, such as the intensification and acceleration of climate change and ecosystem degradation, the increase in social inequalities and different human rights violations, and the exclusion of large segments of the population from meeting their basic needs or preserving their way of life and work.

The implementation of an instrument with such potential cannot happen, however, without a certain technical complexity and a collective investment in dialogue between “universes” that do not usually interact, such as science, the financial sector, and civil society organizations, under the leadership of public entities whose function is precisely to mediate and reconcile the legitimate competing needs. This task is as complex as urgent and Brazil, which in a way is entering late in this debate, should no longer remain oblivious to this trend that only tends to grow, whether for internal reasons or for

reasons of international cooperation and integration (including the creation of a more attractive environment for foreign investors who integrate socio-environmental factors into their decisions).

The ten principles presented here are capable of guiding a consistent and comprehensive approach in this direction, to the extent of our needs. This strategy can be built in stages, adopting scientific-technical criteria for setting priorities, combined with pragmatic criteria, such as starting with the mapping of activities with clear positive environmental impacts (to be encouraged) and of those with clear and serious negative impacts (to be discouraged), as well as economic sectors with the most relevant environmental, economic, and social impacts. The study is based on the experiences of the main existing taxonomies and some others in development, along with global initiatives of institutions that develop standards commonly used by the market, such as the Climate Bonds Initiative. Current taxonomies (although many of them will have several further developments to encompass new environmental or social objectives) include those of the European Union, China, Mongolia, Malaysia, Indonesia, Sri Lanka, South Korea, Costa Rica, Colombia, South Africa and Russia. Under development are taxonomies in Singapore, Chile, Mexico, Georgia, and the United Kingdom. Japan and Canada have announced that they are developing taxonomies focusing only in transition activities, but did not publish any draft. The study builds on key lessons from these experiences that may be useful to Brazil in order to elaborate a taxonomy of economic activities, projects and technologies with comprehensive impacts and connected to Sustainable Development.

1 | DEFINITION AND PRIORITIZATION OF ENVIRONMENTAL AND SOCIAL OBJECTIVES

Among the multiple existing environmental and social demands, it is important to prioritize objectives in the elaboration of the Taxonomy, recognising that they are integrated and that not only mitigation and adaptation to climate change are urgent for Brazil, but also the protection and restoration of biodiversity, pollution prevention and control, impacts on tribal people, occupational health and safety, gender and ethnic issues, among many others.

2 | INTEGRATED APPROACH TO ENVIRONMENTAL AND SOCIAL OBJECTIVES

The main lesson learned from the European Union Taxonomy (followed by several others) is the principle we should not label as “green” activities that contribute to one environmental objective while simultaneously harming another (“do no significant harm” principle) or violating social safeguards. The UNEP-FI **Positive Impact Finance** principles already established this need to identify and mitigate negative impacts before an activity can be labeled as having a positive impact. Going beyond this, the integrated approach allows synergies between the different objectives to be exploited.

3 | FOCUS OF TAXONOMY: ECONOMIC SECTORS, TECHNOLOGIES, PROJECTS OR FUNDED COMPANY

It should be understood that taxonomies can be used to classify economic sectors, but this is the exception, as there are many cross-cutting technologies that can be applied to different sectors (reducing energy or water consumption, managing waste, etc.), as well as projects (green infrastructure, renovations in buildings to improve energy efficiency, etc.) that also need to be labeled and, moreover, taxonomies can be used to assess the degree of sustainability of different companies of the same economic sector.

4 | IDENTIFICATION OF KEY PERFORMANCE INDICATORS (KPIs) AND THEIR WEIGHT BY ECONOMIC SECTOR

In order to measure the social, environmental and climate performance of companies that operate in the same sector, it is necessary to understand which factors of their production process offer risks or impacts (positive and negative), assigning them a weight proportional to this relevance. The definition of these indicators enables us to establish performance parameters that can range from very negative to very positive socio-environmental impacts. Current standards, such as those of the IFC and **ENCORE (of the UNEP-WCMC)**, can be used as a starting point.

5 | MAPPING OF NEW TECHNOLOGIES OR ECONOMIC ACTIVITIES IN TUNE WITH SOCIAL AND ENVIRONMENTAL OBJECTIVES, ALONG WITH OBJECTIVE IMPACT INDICATORS

Some of the existing taxonomies have chosen to focus only on sectors with the highest greenhouse gas emissions. However, this approach leaves out precisely those new activities, sectors, and technologies towards which the economy needs to move, so that a specific mapping is needed in order to include them.

6 | DEFINITION OF IMPACT CATEGORIES, WITH THE PURPOSE OF IDENTIFYING ACTIVITIES THAT SHOULD GRADUALLY CEASE TO BE FINANCED, THOSE THAT SHOULD BE PRIORITIZED, AND THOSE THAT ARE ON THE WAY TO TRANSITION

Another essential principle is that the taxonomy should not be binary, since the reality of our economy is not either. There are many nuances on the pathway to sustainability (and also in the field of activities that produce negative impacts) and it makes no sense to close our eyes to this reality, so the taxonomy should not be binary, as there are different degrees of positive and negative impacts. Furthermore, for the most relevant economic sectors (in terms of participation in GDP, jobs created, tax revenues, exports, and also in terms of socio-environmental and climate impacts), it is necessary to identify stages of transition towards sustainability, which does not happen overnight. We propose, therefore, that a Brazilian taxonomy include 7 categories:

I – activities, projects and technologies whose environmental and/or social impact has a very high positive balance (dark green), therein considered all relevant environmental and social impacts, positive and negative, both from a qualitative and quantitative perspective;

II – activities, projects, and technologies whose environmental and/or social impacts have a positive balance of medium/high (green) level, taking into account all relevant positive and negative environmental and social impacts, both from the qualitative and quantitative points of view;

III – activities, projects, and technologies whose environmental and/or social impact has a positive balance (light green), therein considered all relevant positive and negative environmental and social impacts, both from a qualitative and a quantitative perspective;

IV – activities, projects and technologies whose environmental and/or social impact has a relatively neutral balance (yellow), as such considered both from a qualitative and a quantitative perspective, either because there are no relevant environmental and social impacts, or because the positive and negative impacts are equivalent;

V – activities, projects and technologies whose environmental and/or social impacts have a low negative balance (light red), therein considered all relevant environmental and social impacts, negative and positive, both from a qualitative and a quantitative perspective;

VI – activities, projects, and technologies whose environmental and/or social impacts have a medium negative balance (red), taking into account all relevant negative and positive environmental and social impacts, both from a qualitative and a quantitative perspectives;

VII – activities, projects, and technologies whose environmental and/or social impacts have a very negative balance (dark red), taking into account all relevant negative and positive environmental and social impacts, both from a qualitative and a quantitative perspectives.

7 | CONSIDERATION OF THE LOCATION OF ECONOMIC ACTIVITIES (AND OF THE VALUE CHAIN, WHEN RELEVANT)

The location of implementation and operation of economic activities and the most relevant elements of their value chain should be considered, whenever possible, for the application of taxonomies, including the suitability and location of economic activities in light of the applicable territorial planning normative instruments, such as, in Brazil, the Ecological-Economic Zoning or the Agricultural Climate Risk Zoning. It is clear that, in a continental country like Brazil, considering the different characteristics of the biomes, watersheds and microclimates associated with them, as well as the location of traditional communities (such as indigenous, freed-slave descendants and many others), an activity that could be considered sustainable in one place may not be in another, due to different environmental or social vulnerabilities.

8 | DEFINITION OF TAXONOMY USES

The possible uses cover, broadly speaking, three fields:

- a) the **labeling of financial products** (in the case of Colombia and Mongolia, for example, it is clear that the taxonomy can be used for green credit, public or private bonds and green investment funds, and even for insurance and other financial products; in the case of the EU, the Delegated Act 2178/2021 or Sustainable Finance Disclosure Regulation specifies its use for capital market financial products);
- b) **sustainability report for companies that raise funds in capital markets** (as required by the EU taxonomy), the classification of activities in the portfolio of financial institutions (also required by the EU taxonomy), which may lead to differentiated prudential treatment by Central Banks (as indicated in the Natixis study); and the possible
- c) use for **public policies** (participation in biddings, tax incentives, etc).

9 | PRINCIPLES FOR ELABORATION AND GOVERNANCE

Channels of dialogue with civil society entities and with companies (and their associations) that operate in the economic sectors addressed by the taxonomy should also be created. Formal mechanisms (receipt of written contributions, to be duly analysed) and also more interactive ones (such as workshops and debates, in person or online) need to be established, with wide dissemination, to encourage and optimize the participation of all those with relevant perspectives to add.

Regarding its implementation, it is important to note that monitoring and verification mechanisms will be needed, self-scoring being not enough, especially when it comes to activities that require the measurement of certain parameters.

10 | METHODOLOGY FOR CONSTANT UPDATE, IN LIGHT OF SCIENTIFIC AND TECHNOLOGICAL EVOLUTION

Taxonomies need to evolve over time to incorporate the conclusions of new scientific studies and technological improvements in each economic activity (capable of reducing negative impacts or amplifying positive ones), adopting more advanced criteria than those initially foreseen and adjusting to new contexts, such as the reduction in cost of certain technologies or their availability in the market for which they are intended.



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