Technical Screening Criteria and Taxonomies for Environmentally Sustainable Activities and their Financing – The MSME Dimension

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Abstract

Currently there are several methodologies to create Technical Screening Criteria (TSC) that lead to Taxonomy Frameworks of what constitute environmentally sustainable economic activities. These methodologies are founded on the Paris Agreement, and are principle-based with several common principles. There are essent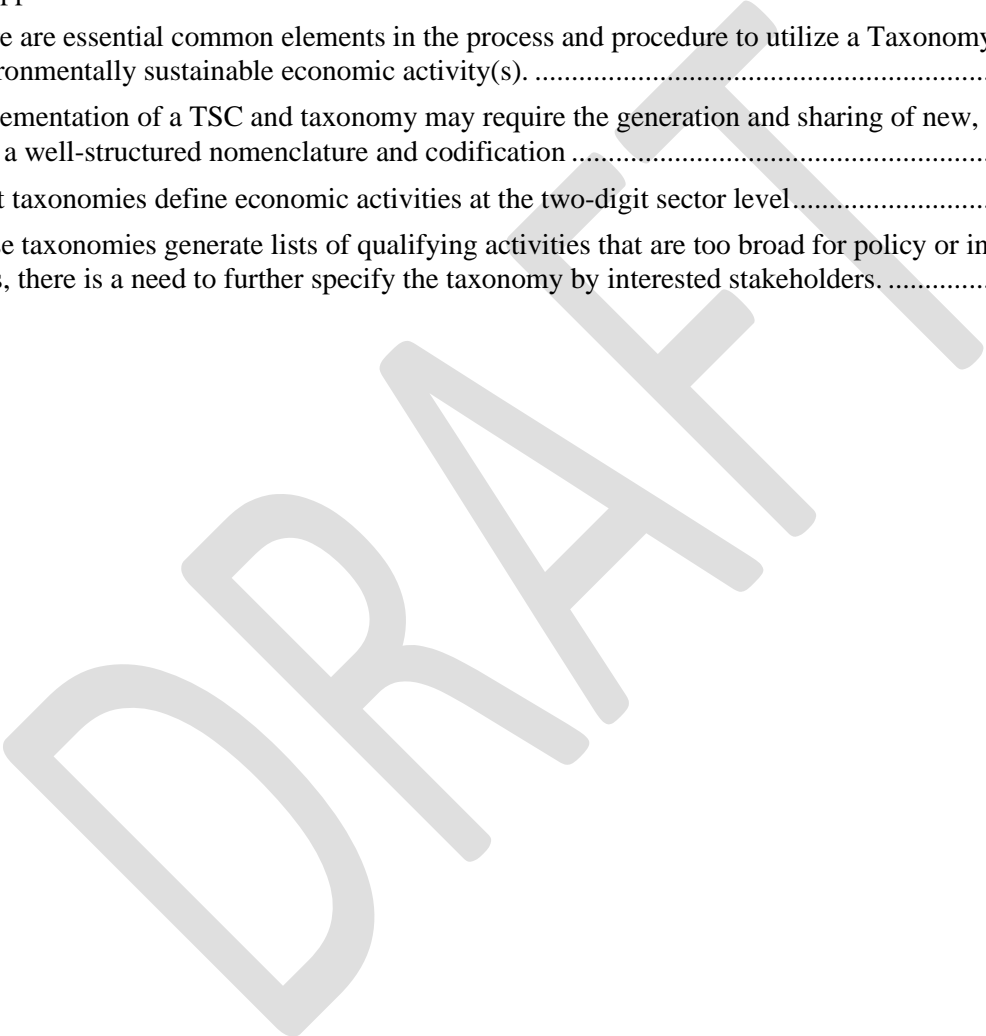ial common elements in the process and procedure to utilize a TSC and taxonomy to finance environmentally sustainable economic activity(s). Implementation of a TSC and taxonomy may require the generation and sharing of new, additional data with a well-structured nomenclature and codification. Most taxonomies define economic activities at the two-digit sector level, that are too broad for policy or investment targets. Thus, there is a need to further specify the taxonomy by interested stakeholders.

Currently there are several methodologies to create Technical Screening Criteria (TSC) that lead to Taxonomy Frameworks of what constitute environmentally sustainable economic activities. These TSC and frameworks identify and classify economic activities by environmental characteristics and environmental policy objectives, and allow for the determination if and how much of an economic activity qualifies as environmentally sustainable economic activity. The following is a selected list of TSC and Taxonomy Framework methodologies:[1]

1. *The European Union (EU) Taxonomy:*[2] An EU classification system for environmentally sustainable economic activities. The document sets out a *Technical Screening Criteria (TSC)* for 67 activities across 8 sectors that can make a substantial contribution to climate change mitigation and adaptation. The European Commission's long-term decarbonization strategy proposes that Europe aim for carbon neutrality by 2050 as part of global efforts to reach Paris Agreement goals.

2. *Climate Bonds Initiative (CBI) Taxonomy:*[3] A guide that delineates the criteria for projects and assets to be aligned with the Paris Agreement.

3. *International Capital Market Association (ICMA) Green Bond Principles:*[4] A set of voluntary process guidelines for issuing green bonds. It provides issuers with guidance on the key components involved in launching a credible Green Bond; it aids investors by ensuring availability of information necessary to evaluate the environmental impact of their Green Bond investments; and it assists underwriters by moving the market towards standard disclosures to facilitate transactions.

4. *Loan Market Association (LMA) Green Loan Principles:*[5] A high-level framework of market standards and guidelines, providing a consistent methodology for use across the green loan market, whilst allowing the loan product to retain its flexibility, and preserving the integrity of the green loan market while it develops

5. *Environmental, Social, and Governance (ESG) goal rating agencies* also provide possible useful methodologies and taxonomies.

These methodologies are based on the Paris Agreement *under the United Nations Framework Convention on Climate Change (UNFCCC).* [6] Some of the high-level details of the Agreement are as follows:

- The Paris Agreement is a legally binding international treaty on climate change. It was adopted by 196 Parties at COP 21 in Paris, on 12 December 2015 and entered into force on 4 November 2016.
- Its goal is to limit global warming to well below 2, preferably to 1.5 degrees Celsius, compared to pre-industrial levels.
- To achieve this long-term temperature goal, countries aim to reach global peaking of greenhouse gas emissions as soon as possible to achieve a climate neutral world by mid-century.
- Implementation of the Paris Agreement requires economic and social transformation that is based on the best available science.

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[1] This list was extracted from "Institutional Banking Group Sustainable & Transition Finance Framework & Taxonomy" June 2020, downloaded August 15, 2021 < https://www.dbs.com/iwov-resources/images/sustainability/responsible-banking/IBG%20Sustainable%20%26%20Transition%20Finance%20Framework_Jun2020.pdf?pid=DBS-Bank-IBG-Sustainable-Transition-Finance-Framework-Taxonomy >

[2] EU (18 June 2019) Technical Expert Group on Sustainable Finance (TEG) Report on EU Taxonomy. https://ec.europa.eu/info/files/190618-sustainable-finance-teg-report-taxonomy_en . https://ec.europa.eu/info/publications/sustainable-finance-teg-taxonomy_en

[3] CBI (October 2019) Taxonomy. https://www.climatebonds.net/standard/taxonomy

[4] ICMA (June 2018) Green Bond Principles. https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/June-2018/Green-Bond-Principles---June-2018-140618-WEB.pdf

[5] LMA (11 December 2018) Green Loan Principles. https://www.lma.eu.com/documents-guidelines/documents/category/green--sustainable-finance

[6] For further details see https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement and PDF document https://unfccc.int/sites/default/files/english_paris_agreement.pdf

- Mitigation and adaption to climate change will require financial products and services tailored for environmentally sustainable economic activities.

These methodologies are principle-based with several common principles for developing a Technical Screening Criteria that leads to a comprehensive taxonomy for classifying if, how and the degree at which a specific economic activity complies with stated environmental and social sustainable goals. Most TSC include, among others, the following principles:

1. A TSC must be based on the best available evidence and technology;
2. include regional conditions, sectorial characteristics, and temporal dynamics of the climate change process as well as *Transitioning* phases (e.g., starting period baseline conditions and expected changes over a specified timeframe);
3. where possible, be based on quantitative targets and verification processes;
4. Where quantitative targets are not available or insufficient to capture the nature of the economic activity, qualitative measures should be used.

An applicable TSC should have additional critical distinctions, among them are:

i. *Climate change mitigation* objectives and strategies to reduce the causes and impacts of climate change;
ii. *Climate change adaptation* objectives and strategies for altering economic activities or their modalities to adjust to, and take advantage of, climate changes, including adaptive capacity, strengthening resilience and reducing vulnerability to climate change;
iii. *Adaptation or mitigation by* economic activities that are implemented by a specific economic agent or a specific set of economic agents, and directly impact the implementing agent(s). In economic terms this is referred to as *Direct Impact*; [7]
iv. *Adaptation or mitigation of* economic activities that lead to positive climate change impacts that benefit not only the economic agent(s) that implements a specific qualifying economic activity or activities, but also benefits others, be they other firms, other people or the environment itself. For example, a firm replaces a less efficient energy production unit with a more efficient unit, which reduces the implementing firm's energy production costs, but also reduces the pollution byproducts released in the environment. In economic terms, the impacts accrued to others are referred to *Indirect Impacts* and *Induced Impacts*. The sum of all three impacts (Direct + Indirect + Induced) is the *Total Impact* resulting from the qualifying economic activity(s). These three notions of impacts are critical for financing qualifying activities, as well as for assessing their environmental, economic, and social impacts over time;
v. *Transitioning activities* that lead to a shift from "brown" to "green" activities;
vi. *Do no significant harm (DNSH)* to the environment, healthy ecosystems (including healthy social and economic ecosystems), or to climate mitigation or adaptation efforts.

There are essential common elements in the process and procedure to utilize a Taxonomy to finance environmentally sustainable economic activity(s).

Thus, these TSC are activity-based, and the Paris Agreement recognizes the need to finance these economic activities to foster climate change mitigation and adaptation to meet the Agreement policy objectives. EU regulations and the EU Taxonomy identify insurance firms, investment firms, venture capital firms, investment funds, and pension funds as financial market participants that will need to comply with regulations regarding disclosure of sustainability risks and sustainable investments. Commercial banks do not fall under these regulations, but the EU Taxonomy suggests that banks can use the Taxonomy on a voluntary basis.

There are two essential common steps in the process for utilizing a taxonomy to finance environmentally sustainable economic activity(s).

1. Use the Technical Screening Criteria to identify eligible economic activities conducted or to be conducted by the firm(s) or financial entity(s);

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[7] For further details see Input-Output models, < https://en.wikipedia.org/wiki/Input%E2%80%93output_model >

2. Calculate the portion of the qualifying economic activity(s) that qualify with the taxonomy. This is the portion that would qualify for sustainable financing. For *Credit Guarantee Schemes* (CGS), this calculation can be applied to a specific loan or to a portfolio of loans it wishes to guarantee.

Implementation of a TSC and taxonomy may require the generation and sharing of new, additional data with a well-structured nomenclature and codification. The calculations required by a TSC and taxonomy will employ detailed, technical information on the qualifying economic activity(s).

For some activities, such as the installation of machinery that reduce the use of raw material inputs, or the pollution by products, the required technical information will need to be first provided by the firm producing these machineries. Hence, there will be a need for a process to generate, and share technical information for many products and procedures in a consistent and comprehensive manner that is easily and broadly available. This process will most likely entail collaboration across machinery producers, service providers and government entities at the national and multinational level.

Thus, assuming the facile availability of consistent and comprehensive information, the firm or group of firms that wishes to implement a qualifying economic activity or set of activities will need to gather and provide this information to financial institutions and possibly regulatory agencies. Thus, financing of qualifying environmentally sustainable activity(s) will require detailed information on the intended, ex-ante, use of funds, as well as actual, ex-post, use of funds. This data reporting requirement might prove a significant challenge for MSMEs, especially for Micro and Small enterprises, that may be less prepared to gather this information. Thus, there will be a need for subsidized technical assistance for these MSME's.

More specifically, commercial banks that wish to provide loans for qualifying activities, credit guarantee schemes that wish to guarantee these loans, or governments that wish to regulate or incentivize lending for qualifying economic activities will require the intended, or ex-ante, *Use of Loaned Funds*, also known as intended *Use of Loan Proceeds* or *Use of Proceeds*. In addition, assessing the ex-post impacts as well as compliance with loan covenants of a specific activity or set of activities will require information on the actual, ex-post, use of proceeds.

Lending institutions must gather and retain these use of proceed data at the individual loan level. Then if needed, these loan level data can be aggregated at the portfolio level. Credit guarantee schemes likewise must also gather and retain these loan-level data, and if needed then aggregate them at the portfolio level. These loan-level data are necessary for the identification and assessment of (i) credit and environmental risks, (ii) loan compliance, and (iii) the impacts of these loans and underlying qualifying activities.

Thus, different data are to be gathered by different firms, and shared with different financial institutions and different government entities, possibly across the globe. Management of this complex data infrastructure, will require that each data concept have a *Structured Nomenclature* and a *Structured Code*. The Structured Nomenclature will facilitate the identification of a discrete set of (i) qualifying <u>activities</u>, (ii) participating <u>agents</u> (such firms, financial institutions, and regulatory agencies), and (iii) <u>impacts</u> be they environmental, economic, or social. A *Structured Mnemonic Code* will facilitate the sharing and analysis of these data across agents and computer systems. For example, a specific economic activity will have a specific name, and a specific Mnemonic code that identifies (i.e., codes) the activity and its characteristics. Indeed, the structure of the Mnemonic code will greatly impact the computer coding required to track and analyze these loans and qualifying activities.

Most taxonomies define economic activities at the two-digit sector level
For example, the EU Taxonomy uses two principles for categorizing high priority sectors:

1. *High-emitting sectors* based on quantitative data on CO2e emissions, and;

2. *Enabling sectors* Where economic activities in these sectors have the potential to enable substantial Green House Gas emissions reductions in other sectors, and where the life cycle emissions of the activity do not undermine mitigation objectives.

The EU Taxonomy then identifies and provides descriptive categories for high-priority activities for the following seven sectors:
1. Agriculture, forestry and fishing;
2. Manufacturing;
3. Electricity, gas, steam and air conditioning supply;
4. Water, sewerage, waste and remediation;
5. Transportation and storage;
6. Information and Communication Technologies (ICT);
7. Buildings (Construction and real estate activities, with application to other sectors where appropriate).

These taxonomies generate lists of qualifying activities that are too broad for policy or investment targets. Thus, there is a need to further specify the taxonomy by interested stakeholders.
Recent reports indicate that the application of the EU Taxonomy has led to classification of "green" financial products such as bonds, and equity funds that do not materially differ from other bonds or equity funds, i.e., the greenwashing of financial products, which in turn causes a dilution of the taxonomy targeting function. [8]

Thus, interested stakeholders will need to collaborate to develop more discrete lists of qualifying activities and qualifying entities that would be eligible for environmentally sustainable financing. Interested stakeholders may include the following:

1. *Multilateral government groups* such as the G20 that can play the leading role in coordinating efforts for fostering members' coherent financing targets and products for qualifying activities;
2. *Governments* at the national, regional level that will regulate the financing of qualifying activities.
3. *Multilateral financial organizations* such as the World Bank Group, European Bank for Reconstruction and Development (EBRD), the Asian Development Bank (ADB), that could play a critical role in assisting less developed countries develop TSC and Taxonomy, as well as financing targets and products;
4. *Multilateral research-centric organizations* such as the OECD and the ASEAN that can play a critical role in providing much needed applied research;
5. *MSME financing centric associations* that focus on MSME financing such as the European Association of Guarantee Institutions (AECM), the Global Network of Guarantee Institutions (GNGI), the IFC SME Finance Forum, and the Global Partnership Financial Inclusion (GPFI) could play a critical role in establishing the characteristics of environmentally sustainable financial products suitable for MSME financing;
6. *MSME centric academic institutions* such as the International Network for SMEs (INSMEE) and the International Council for Small Business (ICSB) can provide much needed academic research;
7. Non-financial sector association will play a critical role in generating the technical characteristics used to develop TSC at the sectorial, industry, and specific product level.

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[8] See Reuters "*Fifty shades of green: EU sustainable fund rules muddy the waters*", August 19, 2021< https://www.reuters.com/business/sustainable-business/fifty-shades-green-eu-sustainable-fund-rules-muddy-waters-2021-08-19/ >, downloaded August 17, 2021; and Reuters "EU sustainable investment rules need better corporate data - banking report", January 26, 2021, < https://www.reuters.com/business/sustainable-business/eu-sustainable-investment-rules-need-better-corporate-data-banking-report-2021-01-26/ >, downloaded August 23, 2021.