BLOG POST

Harmonized Taxonomies: A Cornerstone for Sustainable Finance

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July 1st, 2024

In the evolving landscape of sustainable finance, the word taxonomy has become a standard, but what does it really mean? According to the International Capital Market Association (ICMA), a taxonomy functions as a classification framework that identifies activities, assets, and project categories that meet important climate, environmental, social, or sustainable goals. Some taxonomies define eligibility criteria quantitatively, such as absolute and relative performance thresholds, while others use qualitative or process-based criteria. Alternatively, certain taxonomies might simply list and describe projects, assets, and activities that deliver on key sustainability objectives.[1] This categorization is essential for ensuring consistency, transparency, and credibility. It also helps drive investments effectively, ensuring that funds are directed towards projects that genuinely contribute to sustainability.

There are established market-based taxonomies developed by industry experts, and an increasing number of official taxonomies designed for financial product classification, information disclosure, and risk assessment purposes. These taxonomies are intended to assist investors, financial institutions, and companies in aligning their financial and investment decisions with environmental and social goals.[2]

Taxonomies are essential to support the flow of climate finance. In general, climate finance flows have been distributed unequally across different regions of the world. 75% of all climate finance flows have been concentrated in North America, Western Europe, and East-Asia and the Pacific (primarily in China), while Latin America and the Caribbean (LAC) has only received 6% of total allocated climate finance flows. [3] Sustainable finance taxonomies are a way to further foster the growth of climate finance flows in regions such as LAC where the distribution has been relatively low compared to other countries.

THE LANDSCAPE OF SUSTAINABLE FINANCE TAXONOMIES IN LAC

Concrete steps have been taken towards climate action through the development of national taxonomies in LAC. [4] To date, four countries in the region have published their taxonomies: Panama, Colombia, and the Dominican Republic published Green Taxonomies, and Mexico was the first country in the world to publish a Sustainable Taxonomy which included both Green and Social classifications. Other countries such as Argentina, Chile, Brazil, Peru, Costa Rica, Guatemala, Ecuador, and Honduras are currently working on the development of their own taxonomies.[5]

These initiatives reflect the region's commitment to aligning financial and investment practices with environmental and social objectives, thereby contributing to global sustainability efforts. But, to ensure these taxonomies are effective, we must address current challenges and understand that while a harmonized taxonomy promotes clarity and transparency, a standardized one can cause market confusion, regulatory gaps, and disrupt international capital flows.

WHAT DOES TAXONOMY HARMONIZATION MEAN?

It is crucial to consider that taxonomies should be harmonized, but not standardized. The main reason for this lies in the fact that countries have different economic, social and environmental conditions, making it ineffective and unrealistic to establish the same criteria for all. [6] Instead of imposing a one-size-fits all approach, it is more beneficial to adapt taxonomies to the specific realities of each nation, allowing for flexibility and relevance in their application. [7]

However, when we talk about harmonized taxonomies, we refer to taxonomies that are consistent with global objectives and that facilitate the achievement of climate change mitigation and adaptation objectives established by the Paris Agreement. It is essential that these taxonomies reflect a commitment to sustainability and are aligned with international standards. Also, to ensure greater alignment between regional and national taxonomies can be advantageous in countries with significant cross-border trade.[8] This harmonization can foster greater cohesion and cooperation among different markets and regions.

Additionally, further harmonization can improve market clarity.[9] Clear and precise definitions of what is considered green or social can facilitate the mobilization and allocation of capital, attracting investments towards sustainable projects. Additionally, greater clarity helps prevent greenwashing, ensuring the investments labeled as sustainable truly meet strict criteria. This also reinforces the credibility of sustainable finance, blinding trust among investors and other stakeholders.[10] In **Figure 1**, we can see a flowchart that briefly explains the harmonization of LAC taxonomies.

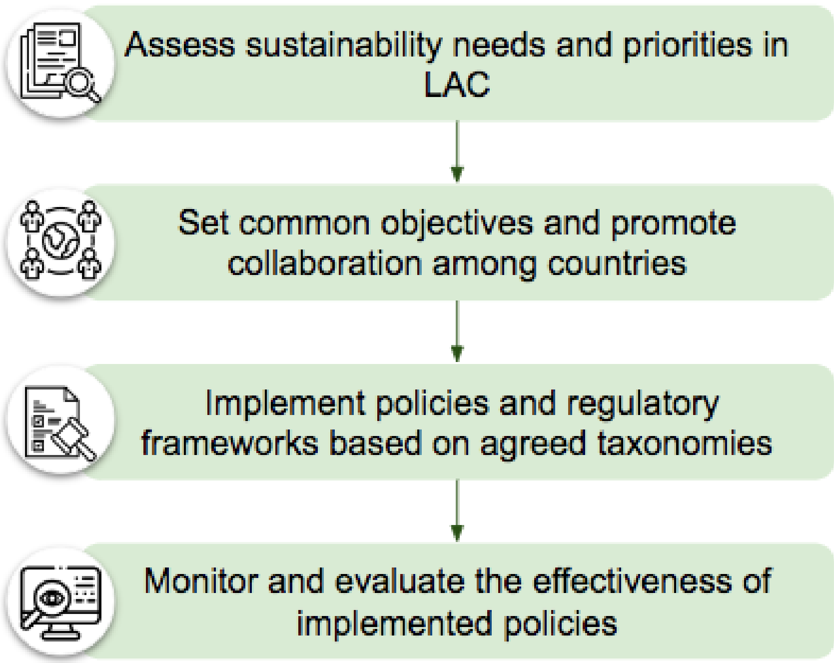

Figure 1. Harmonization of Sustainable Taxonomies in LAC

The harmonization of taxonomies is an essential step towards advancing a sustainable future. It allows it to be customized to local realities, fosters international cooperation, and ensures that sustainable investments are genuine and effective. This approach benefits not only financial markets but also the environment and society as a whole.

CONCLUSIONS

To summarize, the development and implementation of taxonomies in sustainable finance is vital for guiding investment towards activities that align with environmental, social, and sustainability objectives. These classification systems help clarify what constitutes a "green" or "sustainable" investment, and aiding investors, financial institutions, and companies in making informed decisions that support border sustainability goals [11]. Latin America's proactive stance, with countries like Mexico, Panama, Colombia, and the Dominican Republic leading the way, demonstrates a regional commitment to integrating sustainability into financial practices. This progress is crucial for global sustainability efforts.

However, significant challenges remain due to the lack of global agreement on standards and thresholds for sustainability. This fragmentation leads to market confusion, regulatory gaps, and interferes with efficient cross-border capital flows.[12] The creation of customized national taxonomies need to address local contexts, but this sometimes complicates the global landscape. Addressing these issues requires greater international coordination and alignment to ensure that taxonomies effectively support the global climate agenda and facilitate a coherent approach to sustainable finance.

To maximize the benefits of taxonomies, they must be flexible, adaptable, and continuously updated to reflect new scientific evidence and stakeholder feedback.[13] Well-designed taxonomies enhance market clarity and integrity providing robust criteria that prevent greenwashing and ensure genuine sustainability. [14] As the financial world increasingly embraces sustainable practices, minimizing fragmentation and enhancing global coherence in taxonomy development will be essential for scaling up transition finance.

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