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ISF Briefing Note: Canada's Transition & Green Taxonomy

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What are Taxonomies?

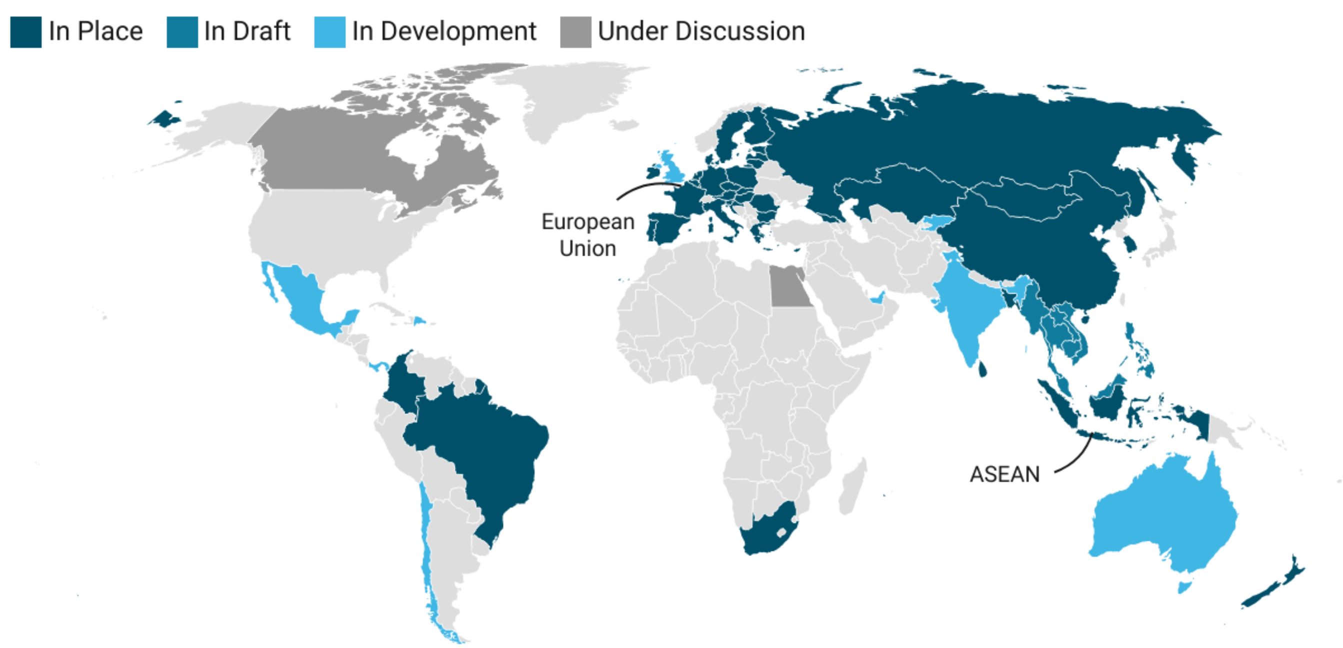
The dictionary defines taxonomies as *"the science of classification; laws and principles covering the classifying of objects"*.[1] For our purposes, a sustainable taxonomy provides a classification system for identifying activities or assets that deliver on sustainability objectives including climate change mitigation and adaptation.

What Role do Taxonomies Play in Sustainable Finance?

By providing transparent and robust definitions that enable the credible identification of sustainable activities or assets, taxonomies address existing informational challenges that hinder the sustainable finance market. The European Commission's High-Level Expert Group on Sustainable Finance identified the establishment of a taxonomy as a priority in their 2018 report, stating that "if Europe is to mobilise capital at scale for sustainable development, it needs a technically robust classification system to establish clarity on what is 'green' or 'sustainable'" (p. 13).[2] The Canadian Expert Panel on Sustainable Finance noted similar findings in their 2018 interim report, which states that *"accurate labeling enables the financial sector to more strategically identify and address sustainable growth prospects with a reasonable view of relative risk and opportunity"* (p. 33).[3] (More on the Canadian Contribution and Opportunity below). In essence, taxonomies are tools that promote the allocation of capital toward certain activities. They are necessary to prevent "greenwashing" behaviour and are central to the proper functioning of markets for green bonds, transition financing, and other sustainable investments.

The Global Landscape

Global Taxonomy Development

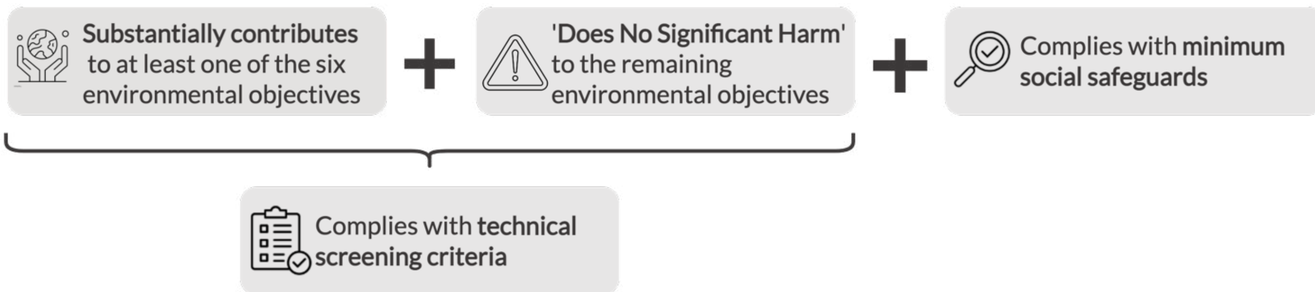


Map: The Institute for Sustainable Finance

In recent years, taxonomy development has rapidly accelerated, with efforts at the national, regional, and multilateral levels. This momentum has, in large part, been driven by rising interest from policy makers and financial regulators in taxonomies and the role they can play within policy frameworks for sustainable finance. By mid-2022, upwards of 30 country- and regional-level taxonomies in varying stages of development are underway globally. This includes the comparatively early efforts in China and the European Union (EU), and more recent initiatives in Colombia, Singapore, South Africa, and the United Kingdom, among others.

The EU Taxonomy for Sustainable Activities and China's Green Bond Endorsed Project Catalogue have been highly influential, with many efforts noted in the map above citing one or both as an important reference. The EU Taxonomy's four-part eligibility approach is particularly noteworthy, as these features, such as the Do No Significant Harm Principle (DNSH), appear frequently in subsequent efforts. A notable implication of the EU approach is that the dual requirements of substantial contribution while avoiding significant harm means that activities must demonstrate a net-positive impact to environmental sustainability to be considered taxonomy-aligned.

Figure 1: *The general eligibility requirements of the EU Taxonomy*



Are There Universally Accepted Taxonomies?

While a universal, globally agreed taxonomy for sustainable finance does not exist at present, establishing one would have certain advantages. The International Network of Financial Centres for Sustainability (FC4S) argued that an internationally compatible taxonomy would:

- Reduce transaction costs.
- Provide a common, foundational starting point for standards, products, and asset classes.
- Enhance market trust and liquidity, and facilitate cross-border financial flows.
- Improve the ability of market participants to express their sustainability preferences.
- Inform additional policy measures for incentivizing sustainable finance.
- And ultimately accelerate transitions towards a sustainable economy.[4]

Despite the benefits, the agreeance of a global taxonomy is unlikely given the heterogeneity of countries and markets. In addition, while "green" is a global concept, that of "Transition" is more local, and focused on the specific structure of different economies. A taxonomy is more likely to be effective if it is designed with a jurisdiction's sustainable development priorities and socio-economic realities in mind.[5] At the same time, the absence of harmonized international standards for sustainable finance, paired with the rapid proliferation of national- and regional-level efforts to develop taxonomies and other sustainable finance tools is frequently identified as a potential source of market fragmentation.[i] This suggests that taxonomies must strike a balance between two imperatives for taxonomy design: (1) a globally consistent approach to reduce cross-border fragmentation risks, and (2) accounting for national economic realities and sustainable development priorities.

i For instance, the lack of harmonized international standards (e.g., data and reporting requirements) was identified as a potential source of fragmentation in sectors undergoing rapid innovation, including crypto-assets and sustainable finance, in a 2019 survey of the International Organization of Securities Commissions' board members.

Recognizing this, several organizations have urged greater international cooperation to foster improved comparability (i.e., interoperability) between existing and emerging taxonomies. This includes the Group of Twenty's (G20) Sustainable Finance Working Group (SFWG), which developed a set of high-level global principles for developing sustainable finance approaches, including taxonomies. The G20 suggests that approaches:

- Ensure material positive contributions to sustainability goals and focus on outcomes.
- Avoid negative contributions to other sustainability goals (such as through DNSH).
- Be dynamic, adjusting when necessary to reflect changes in policies, technologies, and the state of the transition.
- Reflect good governance and transparency.
- Be science-based for environmental goals and science- or evidence-based for other sustainability issues.
- Address transition considerations.[6]

Further to these principles, the G20 also made recommendations on international coordination, including that international organizations, networks and initiatives focus on enhancing technical understanding of and interlinkages between sustainable finance approaches.[6] Notable international initiatives include:

- The International Platform on Sustainable Finance (IPSF). Established in 2019 by authorities from seven countries, including Canada's Department Finance, the IPSF, which has since grown to 18 members, aims to facilitate knowledge exchange and promote best practices in sustainable finance. The group has focused on two initial priority areas: (a) comparing taxonomies and (b) sustainability-related disclosure. The taxonomy workstream has published the Common Ground Taxonomy, the result of an effort to compare China's Green Bond Endorsed Project Catalogue and the EU Taxonomy.
- The Sustainable Banking and Finance Network (SBFN). Established in 2012, the SBFN is a forum of institutions representing 62 emerging market and developing economies that aims to advance sustainable finance in these countries. A working group on sustainable finance instruments has been established with an initial priority to study global taxonomy trends.[7]

Transition: a "missing middle" in sustainable finance

Where they support climate change mitigation objectives, existing sustainable finance taxonomies primarily facilitate the identification of low-carbon or 'green' activities with environmental performance already consistent with 1.5°C-aligned pathways. Facilitating investment towards low-carbon activities is necessary and important; nevertheless, much of the real economy has yet to achieve this level of performance. Considering this, existing taxonomies' coverage is relatively limited when considered within the context of the whole economy.

This lack of coverage has been criticized, with some questioning whether taxonomies of this nature are able to effectively support ambitious environmental transitions. For example, Mark Carney, the UN Special Envoy on Climate Action and Finance, stated in 2020 that a whole economy transition and the mainstreaming of sustainable finance requires moving beyond a rigid dichotomy of green and not-green in favour of an approach that includes a 'transition' bucket in the middle.

Where taxonomies are already in place, such as in the EU,[8] such concerns have prompted efforts to consider expanding existing taxonomy coverage to incorporate further nuance and additional activities, including transition activities. In other regions, where taxonomies are still underway, some have indicated a clear intention to incorporate transition activities at an early stage, including in ASEAN, Australia, and Singapore. Despite signs of progress, work to develop a credible transition-oriented financing approach remains nascent.[9]

Box 1:

What is 'Transition' Finance?

While there is no common definition of the concept, 'transition' financing is distinct from 'green' financing. It can generally be understood to fund emissions reductions on a journey **towards 1.5°C-aligned pathways**, in line with a credible climate transition plan. This may also include the decommissioning (i.e., early retirement) of highly emissive physical assets. This contrasts with 'green' financing to fund **already low- or zero-emitting activities**. Transition-eligible activities in the recently published proposal for a Canadian transition taxonomy are described in Box 2.

Funding for transition projects can also be raised in debt markets with either a use-of-proceeds instrument (see: ISF's Transition Bonds primer), or general corporate purpose instruments with interest rates tied to the achievement of key performance indicators (see: sustainability-linked debt in ISF's Sustainable Debt primer).

The Canadian Contribution and Opportunity

Canada has yet to develop a sustainable finance taxonomy, but there are compelling reasons to do so. First, the unlikeliness of a universal taxonomy being agreed anytime soon means that Canada, like many other countries, should aim to develop a taxonomy that is fit-for-purpose nationally while incorporating emerging international best practices in taxonomy design that will promote its cross-border interoperability. Second, the limited coverage of existing taxonomies limits the utility of their application in Canada, where highly emissive sectors that are historically important sources of economic growth require ambitious emissions reductions to support the Country's overall low-carbon transition.

In 2019, Canada's Expert Panel on Sustainable Finance argued that Canada's economic context and strong financial sector are well-suited for developing a transition-oriented taxonomy. Specifically, the Panel recommended convening "key stakeholders to develop Canadian green and transition-oriented fixed income taxonomies" (p. 28).[10] In 2021, findings included in ISF's *Changing Gears: Sustainable Finance Progress in Canada* report indicated that a Canadian transition taxonomy remains a commonly cited short-term action item among surveyed experts.[11] And while developing a taxonomy would benefit the domestic market and ensure Canada's perspective and participation in further global cooperation and dialogue, the greatest opportunity for Canada lies with developing a "transition" taxonomy that advances existing global practices. In the same way that China and the European Union have influenced green taxonomy design far beyond their own borders, Canada could position itself as a global leader by complementing existing, green-focused taxonomies with a credible, science-based approach for transition finance.

The Taxonomy Roadmap Report

In early 2020, and in response to the Expert Panel's recommendation, the CSA Group began leading a private sector effort to develop a Canadian transition taxonomy, which was the first stage of discussions across players in the Canadian scene. Following those initial conversations, progress has continued under the Sustainable Finance Action Council (SFAC), which was established to advise the Federal Government on market infrastructure for attracting and scaling sustainable finance in Canada. SFAC's Taxonomy Technical Expert Group (TTEG), which the Institute for Sustainable Finance is pleased to be supporting as a core knowledge partner, has recently published the Taxonomy Roadmap Report, outlining ten recommendations to the Government for establishing a Canadian-oriented green and transition taxonomy.

The TTEG believes that a taxonomy would mobilize green and transition finance aligned with Canada's transition pathways; boost investor confidence in and support the growth of a transition finance market in Canada; and serve as a foundational tool across a variety of use cases, including as a key input for formulating credible climate transition plans. The Roadmap Report includes a detailed proposal for a three-tiered governance model for the long-term development and implementation of a taxonomy, and an initial framework architecture for identifying "green" and, importantly, "transition" projects, clearly under separate categories.

Box 2:

Transition-Eligible Projects in the proposed Canadian Taxonomy

'Transition' is defined in the Roadmap Report as "decarbonizing emission-intensive activities that are critical for sectoral transformation and consistent with a net-zero, 1.5°C transition pathway" (p. 13). Ineligible projects include any that are related to solid fossil fuels (e.g., coal-fired power generation) and any that create carbon lock-in or path dependency (e.g., exploration and development of new oil fields). The initial Framework Architecture that will inform further work views transition-eligible projects as those that:

- Decarbonize sectors with **high scope 1 and 2 emissions**, such as iron & steel or cement production. These activities do not generate material downstream scope 3 emissions and, owing to a lack of economic or technologically viable alternatives, operate in markets where demand is expected to remain stable or grow in a global low-carbon transition. These activities face higher carbon-costs in the transition, so projects that ambitiously reduce emissions will improve carbon competitiveness.
    - Example: a steel production facility that installs an electric arc furnace.
- Decarbonize sectors with **high downstream scope 3 emissions**, such as oil & gas. These sectors do generate material downstream scope 3 emissions and, owing to the availability of viable alternatives (e.g., renewables), operate in markets expected to face decreasing demand in a global low-carbon transition. Eligible projects have a well-defined lifespan commensurate with expected global demand-decline in representative 1.5°C pathways, and result in significant emission reductions in existing assets.
    - Example: an existing natural gas production facility with a short to moderate lifespan installing world-leading methane capture.

Endnotes

1 'Taxonomy', Collins Dictionary.

2 Financing a Sustainable European Economy, High-Level Expert group on Sustainable Finance, 2018.

3 Interim report of the Expert Panel on Sustainable Finance, 2018.

4 Building Shared Language for Green and Sustainable Finance – Expert Briefing on the Development of Taxonomies, the International Network of Financial Centres for Sustainability, 2018.

5 Developing a National Green Taxonomy: A World Bank Guide, the World Bank, 2020.

6 2021 Synthesis Report, G20 Sustainable Finance Working Group, 2021.

7 Sustainable Finance Instruments Working Group, SBFN.

8 Final Report on Taxonomy extension options supporting a sustainable transition, Platform on Sustainable Finance, 2022.

9 Transition Finance: Investigating the State of Play, Aayush Tandon (OECD), 2021.

10 Final Report of the Expert Panel on Sustainable Finance, 2019.

11 Changing Gears: Sustainable Finance Progress in Canada, ISF, 2021.