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Classification Approaches in Sustainable Finance Regulation

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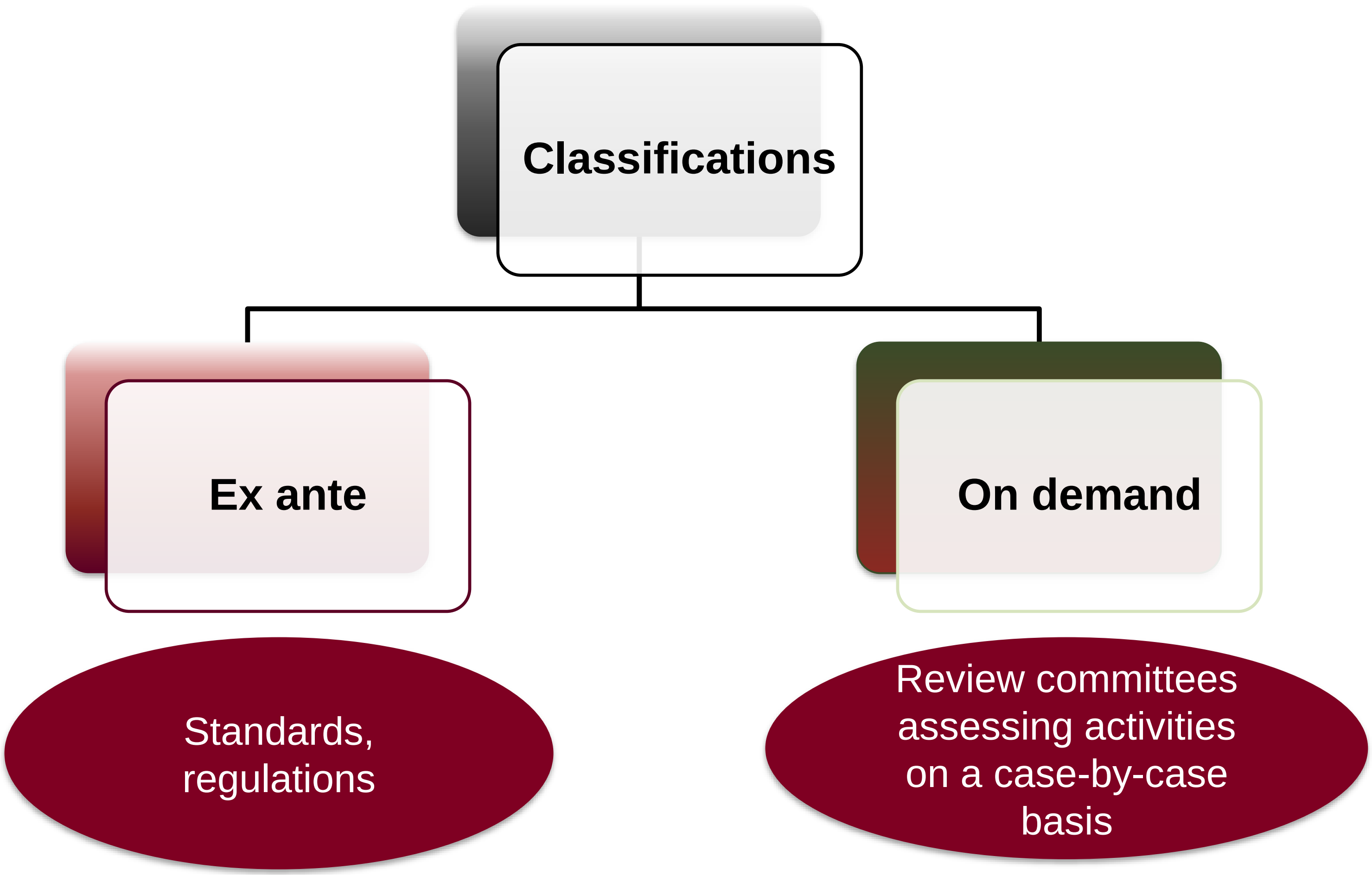
CLASSIFICATIONS IN SUSTAINABLE FINANCE

Classifications are key in sustainable finance --- they enable for the **identification** of sustainable **activities and investments**.



CLASSIFICATIONS ON DEMAND: PROS AND CONS

Principle-based, leaving **discretion** to the committee in assessing activities on a case-by-case basis

Lack transparency, increasing legal uncertainty. They might work in transactions between banks and the central bank.

Not suitable as market-wide tools

EX ANTE CLASSIFICATIONS: PROS AND CONS

Transparency and legal certainty

Lenghty and difficult to apply due to detailed provisions being included

SUSTAINABLE FINANCE TAXONOMIES

1

- Classification systems introduced in several jurisdictions through a **taxonomy** (**EU, China, Bangladesh**)

2

- Taxonomies provide **common terminology along with criteria** to identify sustainable economic activities and investments

3

- To define activities or investments as **green or sustainable,** they need to meet criteria (e.g. **thresholds or performance levels**)

CRITICAL ISSUES

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Taxonomies --- **useful tools to channel investments** towards sustainable activities.

Yet, they face a number of **issues**:

1. Technical **criteria** (performance thresholds) are **complex to analyse and assess** for businesses and financial institutions

2. **Data on taxonomy alignment** are **costly** to **produce** for businesses and costly to **assess** for financial institutions

3. Taxonomies have a **binary approach** ('**winner-takes-all-character**'), so most activities not able to reach demanding requirements despite being sustainable-oriented

TAXONOMY BINARY APPROACH

Binary approach reduces ability to channel investments towards sustainable activities.

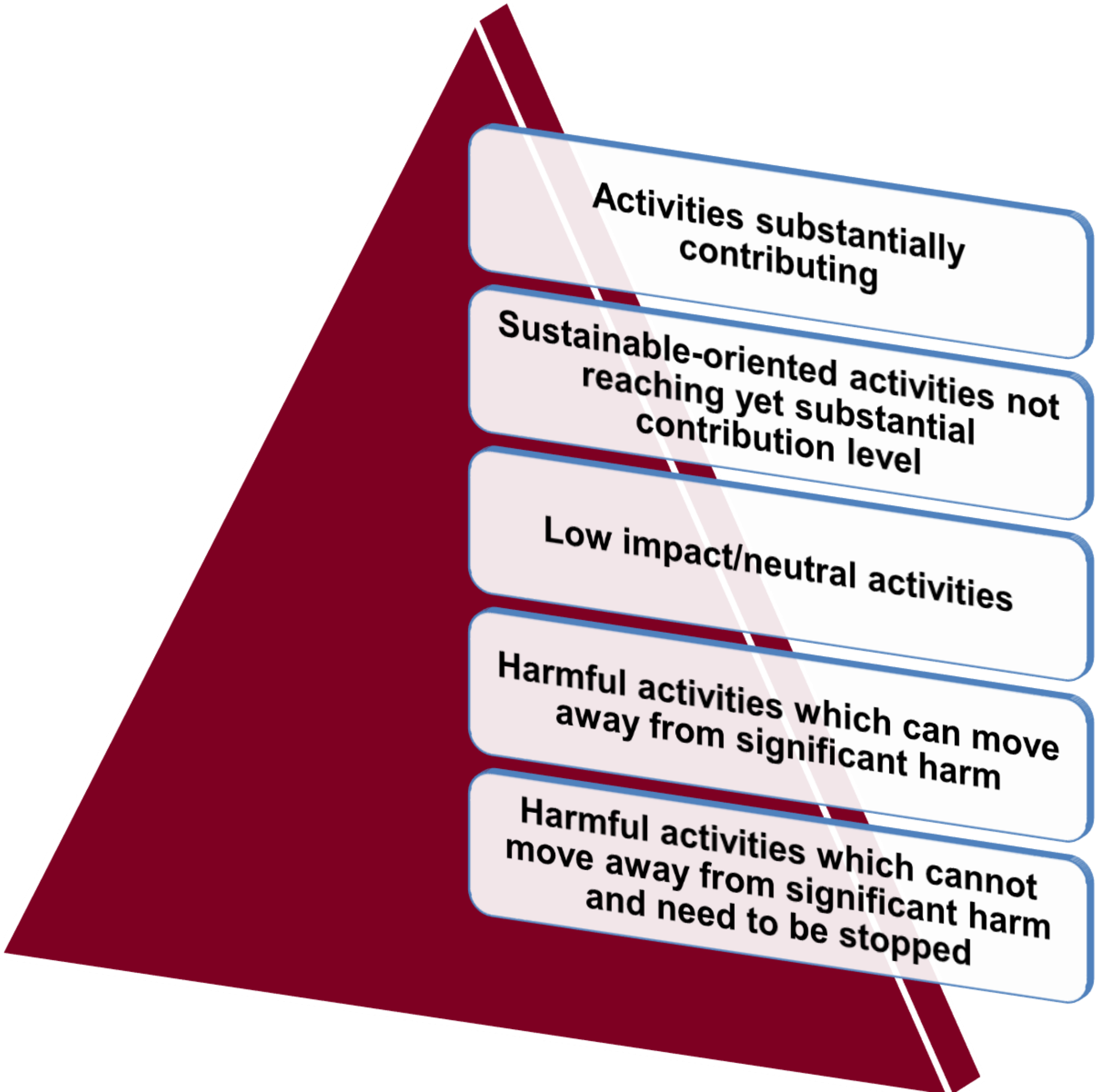
PSF has published a **report arguing in favour of a taxonomy extension** to include:

1) harmful activities which cannot move away from DNSH
2) harmful activities that can move away from DNSH
3) low-impact and neutral activities
4) sustainable activities not reaching the level of substantial contribution yet

Including also these activities in the taxonomy **will help them raise finance to**:

1) stop them
2) move away from the condition of being harmful
3) invest in sustainable assets/goods
4) improve and reach the substantial contribution level

TOWARDS AN EXTENDED EU GREEN TAXONOMY



AN ALTERNATIVE TO BINARY APPROACHES: SCORECARD APPROACH

- An **alternative** to binary approaches is a **scorecard approach**.
- A scorecard approach enables to **grade activities with different scores** on the basis of their **contribution to sustainability objectives**.
- Contribution would range from **harmful to substantial**, **with nuances** in between.
- Benefit --- capture **sustainability-friendly activities** unable to reach substantial contribution as well as **neutral** and **harmful activities**.
- Sustainability-friendly activities --- recognized by the framework, and firms performing them could have access to sustainable finance, **providing incentives.**

3-STEP SCORECARD APPROACH

1) Definition of Social Objectives → 2) Definition of Technical Screening Criteria through Metrics → 3) Definition of Social Thresholds with Score Ranges

SCORING SYSTEM

1) Social Objectives

2) Social Metrics

3) Social Scoring

Objectives	Metrics
1. Tackling inequality	Percentage of female and less represented minorities among employees/executives/directors Percentage of female and less represented minorities among clients/customers
2. Fostering social cohesion	Human rights concerns and controversies relating to employees and customers
3. Fostering social integration	Percentage of clients below the poverty line
4. Fostering labor relations	Collective bargaining and union labor controversies
5. Investment in human capital	Reliance on a highly-skilled workforce and expenses for training
6. Investment in economically- or socially-disadvantaged communities	Investments in areas where economically- or socially-disadvantaged communities are located

Score: 0-10
0-1: socially harmful
2-3: socially neutral
4-7: socially beneficial
8-10: substantial contribution

Any indicator linked to a social objective needs to be **> 1** not to impact negatively any other objective

AN EXAMPLE: MICRO-FINANCE FUND

- A **micro-finance fund** has as **investment objective poverty reduction** through **financing to microfinance institutions** in emerging markets.
- Micro-finance fund's **only economic activity is lending** to micro-finance institutions, with **no significant harm on any identified social objective**.
- Lending to micro-finance institutions is an economic activity **potentially pursuing several social objectives**:

1. **tackling inequality**
2. **fostering social integration**
3. **investment in economically- or socially-disadvantaged communities**

STEP 1: SOCIAL OBJECTIVES RELATIVE TO THE ACTIVITY

1

- Tackling inequality

2

- Fostering social integration

3

- Investment in economically- or socially-disadvantaged communities

STEP 2: SOCIAL METRICS AND THRESHOLDS

- **Tackling inequality**: percentage of female and less represented minorities among employees/executives/directors and clients/customers, i.e. final borrowers

  below 40% = 0-1 (socially harmful)

  between 40% and 60% = 2-3 (socially neutral)

  between 60% and 90% = 4-7 (socially beneficial)

  above 90% = 8-10 (substantial contribution)

- **Fostering social integration**: percentage of clients below the poverty line

  below 40% = 0-1 (socially harmful)

  between 40% and 60% = 2-3 (socially neutral)

  between 60% and 90% = 4-7 (socially beneficial)

  above 90% = 8-10 (substantial contribution)

- **Investment in economically- or socially-disadvantaged communities**: percentage of final borrowers members of economically- or socially-disadvantaged communities

  below 40% = 0-1 (socially harmful)

  between 40% and 60% = 2-3 (socially neutral)

  between 60% and 90% = 4-7 (socially beneficial)

  above 90% = 8-10 (substantial contribution)

STEP 3: SCORING

1

- **Tackling inequality**: 45% women and less represented minorities among employees/executives/directors and clients/customers (average).
- **Score: 2 = socially neutral**

2

- **Fostering social integration**: 70% final borrowers below the poverty line.
- **Score 5 = socially beneficial**

3

- **Investment in economically- or socially-disadvantaged communities**: 80% of final borrowers members of economically- or socially-disadvantaged communities.
- **Score 6 = socially beneficial**

OBSERVATIONS

- Micro-finance fund's lending activity **labelled** as:
  - **socially neutral with regard to tackling inequalities**
  - **socially beneficial with regard to fostering social integration**
  - **socially beneficial with regard to investment in economically- or socially-disadvantaged communities**

- Despite failing to reach substantial contribution, **activity** (**and investments** funding it) **could benefit from being labelled as socially beneficial** with regard to some social objectives.

- **Micro-finance fund could access more investment opportunities with regard to both equity and debt finance**.

STRENGHTS AND WEAKNESSES

- A scoring system could enable **measurement of the degree of contribution to social objectives** made by any given economic activity.
- It would enable to **distinguish between harmful, neutral and sustainable activities** along with activities substantially contributing to social objectives.
- **Transition activities would be incentivised**.
- More granular system would **enable for the creation of accurate labels for financial products.**
- **Need for a third party authority assigning scores**.
- **Detailed legislation/regulation** might be **needed**.

Thank you!