

Lötters-Viehof, Steffen et al.

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The implementation of sustainable finance taxonomies: Learning from South African experiences

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The Implementation of Sustainable Finance Taxonomies: Learning from South African Experiences

Steffen Lötters-Viehof, Sören Hilbrich, Kathrin Berensmann, Giovanna Artmann, Sam Ashman, Theresa Herbold, Agnese Monti, Felix Paffhausen, Stephanie Roigk & Lee-Ann Steenkamp

Summary

To bring our economies on a path to climate neutrality, investments in carbon-intensive production processes have to stop. At the same time, we need to mobilise large amounts of capital for investments conducive to a just transition. Reforming the financial sector in a way that allows this redirection of capital flows to take place is crucial.

As one element of a comprehensive sustainable finance strategy, taxonomies can potentially play a pivotal role in this regard. By providing common definitions for sustainable economic activities, these taxonomies aim to increase transparency on financial markets and help market participants to align their investment decisions with sustainability considerations.

This policy brief presents policy recommendations concerning the implementation of sustainable finance taxonomies based on experiences with the South African Green Finance Taxonomy (GFT). It mainly builds on data collected in semi-structured expert interviews with different stakeholders of the GFT conducted in South Africa between February and April 2023 (Hilbrich et al., 2023).

The implementation phase of the GFT has revealed multiple challenges, including a need for improved regulatory embedding and enhanced capacities on the part of potential users. This has led to a low uptake by market participants. To address these challenges, this policy brief presents four recommendations that are of relevance not only for South Africa but also for many other countries that are currently implementing a sustainable finance taxonomy:

- Voluntary taxonomies are insufficient to facilitate the necessary widespread uptake. Public institutions need to set a credible signal that a taxonomy will indeed become the common standard on the financial market. National regulators should issue guidance notes on taxonomy usage and consider implementing mandatory reporting rules. Regulators or stock exchanges should require issuers of green financial instruments, including green bonds, to align their project eligibility criteria with a sustainable finance taxonomy. In addition, a good coordination and a clear distribution of responsibilities among governance actors is crucial in the implementation phase. A taxonomy can only fulfil its potential if it is meaningfully integrated into an overarching sustainability strategy.
- Taxonomy reporting requires both capacity and expertise. Both market and governance actors need to ensure possibilities for learning and for exchanging specialised knowledge. Pilot studies can help reduce uncertainties and train practitioners on the job.
- A lack of bankable green projects decreases the potential of a taxonomy to redirect capital flows and reduces incentives to adopt a taxonomy. Development banks should provide risk capital and seed funding to help develop green projects.
- Interoperability between different taxonomies is an essential goal. The European Union (EU) should formally recognise taxonomies of other jurisdictions that meet certain standards as equivalent to the EU taxonomy (and communicate under what conditions it is willing to do so). Accordingly, assets shown to align with a particular taxonomy would be recognised as aligned with the EU taxonomy without further assessment.

Introduction

Additional investments of USD 4 trillion annually will be necessary in the Global South if the Sustainable Development Goals (UNCTAD, 2023, p. 30) are to be reached. With this figure having significantly increased in recent years, it is imperative to develop innovative strategies to change the allocation of capital. As one element of a larger policy strategy, sustainable finance taxonomies are a promising instrument that can make a contribution to this path. The pace of global diffusion of sustainable finance taxonomies is remarkable. Over 25 nations have already, or are currently, developing a taxonomy (Cabrera, Youngeun Shin, & Hinojosa, 2022, p. 8).

The intended purpose of a sustainable finance taxonomy is to introduce a common, transparent and comprehensible definition of sustainable economic activities. Disclosure on taxonomy alignment of assets should help market participants to include sustainability considerations in investment decisions (Ehlers, Gao, & Packer, 2021, p. 1).

Ultimately, taxonomies should contribute to shifting capital from unsustainable economic activities to more sustainable activities. As investors are reassured that the sustainability claims of the projects they invest in are not greenwashing, the attractiveness of sustainable investment increases. Shifting capital to sustainable projects can also be driven by the development of new green finance instruments based on a taxonomy.

This policy brief looks at the implementation of the South African Green Finance Taxonomy (GFT) and thereby contributes to the debate on the optimal policy framework for sustainable finance. In particular, the paper formulates recommendations on how sustainable finance taxonomies can be successfully implemented – not only in South Africa but also in other jurisdictions.

The recommendations build on findings of a research project on the factors that influence taxonomy adoption by potential users. To investigate this research question, the team conducted

44 semi-structured expert interviews in South Africa between February and April 2023 (Hilbrich et al., 2023).

The following section describes specifically the situation in South Africa. In the conclusion we then draw lessons learnt from the South African case for implementation processes in other jurisdictions.

The Green Finance Taxonomy in South Africa

Given that South Africa's industrial structure is in need of investment, and the presence of its large financial sector, sustainable finance policies are potentially important levers in the country.

A so-called mineral energy complex (Fine & Rustomjee, 1996) characterises South Africa's economy. The country is highly dependent on fossil-intensive industries, such as energy production through coal, chemical production and the mining of raw materials. The corresponding infrastructure, that of energy in particular, suffers from insufficient investment. Simultaneously, South Africa has significant socioeconomic problems, as indicated by a national unemployment rate of 34.5% (Department of Statistics South Africa, 2023) and one of the world's highest levels of inequality, measured by the Gini coefficient (World Bank, 2022, p. 13).

South Africa maintains a broad domestic financial market with a variety of financial market institutions, such as commercial banks and development banks, insurance companies and pension funds (Carbon Trust, 2021, p. 110ff). In terms of market capitalisation, the Johannesburg Stock Exchange (JSE) is the biggest stock exchange in the continent. Market actors operate in neighbouring countries and dominate the regional markets.

South Africa's preconditions, as a country with a high dependency on fossil resources and profound socioeconomic challenges, call for a transformative dynamic and significant investment in sustainable economic activities and infrastructure.

The GFT is meant to contribute to mobilising these investments.

The GFT arose from a multistakeholder process of governmental bodies and financial market actors collaborating in a so-called taxonomy working group, chaired by the National Treasury. Civil society and labour organisations were not part of the group. The private National Business Initiative and the consultancy Carbon Trust drafted the GFT on behalf of the taxonomy working group and conducted stakeholder consultations. The process was financed by donors. Several pilot studies were conducted in order to test the taxonomy. Ultimately, in April 2022, the National Treasury published the GFT.

The GFT uses a three-step process to assess the sustainability of an economic activity. First, the activity has to provide a substantial contribution to one of the environmental objectives. Currently, this means a contribution to either climate mitigation or adaptation. Secondly, the activity must not do significant harm to the corresponding other goal. Lastly, a minimum of social safeguard standards is applied (National Treasury, 2022b, p. 7ff).

The GFT replicates the structure of the EU taxonomy for sustainable activities. Up to the level of technical screening criteria, both taxonomies share a similar design, underlined by a similarity of 78% of the criteria defining a substantial contribution to one of the environmental objectives (National Treasury, 2022a, p.7f). This similarity is intended to attract investment from the EU.

Although the launch of the GFT in spring 2022 was met with interest, one year later it had, in fact, hardly been applied. This policy brief focuses on four factors that impact the development of such a limited implementation, and recommends measures to address the challenges identified.

Factor 1: Deficiency of regulatory embedding

The GFT suffers from ambiguities regarding the regulatory setting, resulting in a missed opportunity to lead the market towards disclosure of alignment with the GFT. Sufficient leadership, communication and support from South African governance actors, such as the Ministry of Finance, need to be enhanced. Moreover, the GFT is inadequately integrated within national policy frameworks and timeframes, such as the National Development Plan and high-level sustainability policies. The existence of parallel classification systems for sustainable activities spurs doubts that the GFT will indeed provide a common language on financial markets. One example is the climate budget-tagging system for public sector entities, which is currently undergoing a pilot phase. The implementation of the GFT affects the mandates of many different government agencies (and different units within these institutions), including the National Treasury, the Prudential Authority (PA) and the Financial Sector Conduct Authority (FSCA). That responsibilities for the relevant governance measures are so widely distributed makes the implementation more challenging.

In implementing the taxonomy, South Africa has chosen a voluntary approach, meaning that no market participant is obliged to assess whether their economic activities meet the criteria for taxonomy alignment. This approach is associated with the challenge that it is very difficult for individual market participants to assess and disclose on the taxonomy alignment of their portfolios if most others do not. Due to the interrelated nature of financial markets, taxonomy assessments require data from many agents, which is not available if only a few market participants disclose it. On the basis of the findings of this research, it seems questionable whether the voluntary approach of GFT governance is sufficient to achieve the goal of widespread use.

→ **Ensure proactive regulatory leadership**

The limited utilisation of the taxonomy in practical applications highlights the **need for proactive and definitive signals** from responsible authorities, such as the National Treasury, the FSCA, the PA and the JSE.

A clear delineation of responsibilities and good coordination of public authorities relevant to the implementation process is crucial. In this regard, the **Taxonomy Oversight Committee (TOC)**, coordinating and harmonising taxonomy-related activities across relevant institutions, is a potentially central tool. The facilitation of exchange and coordination between regulators is a key responsibility of the TOC.

By communicating their intentions and plans for the implementation of the GFT, regulators, such as the PA and the FSCA, should send clear signals to market participants. **Guidance notes** could serve this purpose. Though non-binding, these notes could encompass the advantages of adopting the taxonomy and furnishing tailored guidance for various applications and user groups. Additionally, the guidance notes may highlight opportunities to streamline reporting processes across different reporting frameworks.

However, it is questionable whether the issuance of non-binding guidance notes will be sufficient to drive taxonomy usages or whether **mandatory disclosure rules** are necessary. By mandating all relevant stakeholders to disclose on GFT-alignment, readily available and easily accessible data would be established, leading potentially to cost reductions as the assessment of GFT-alignment becomes centralised at the company level, enabling all financial market actors to utilise this data for their reporting. In particular, taxonomy assessments of complex financial products or portfolios that requires data from multiple agents would become easier.

In principle, a clear strategy is needed from the lead ministry of finance with regard to the fundamental question of whether taxonomy adoption should be voluntary or mandatory. If a mandatory

approach is chosen, regulatory agencies could enforce requirements for their designated sphere of influence, such as the PA for banks or the FSCA for pension funds. Pension funds control significant investment volumes and can thus be important levers to drive market uptake.

As for private regulation, the JSE could incorporate GFT disclosure in their listing requirements for companies and debt instruments. In addition, the JSE could introduce a segment of GFT-aligned **green bonds**, assuring investors that these bonds follow a credible definition of sustainability. More ambitiously, all green bonds listed at the JSE could be required to be GFT-aligned.

In any case, ensuring seamless **integration of the GFT into existing regulations, disclosure requirements, and financial product standards** remains essential. This integration is vital to avoid redundant reporting systems and to mitigate any potential increase in costs. Moreover, it is essential to refrain from creating parallel classification and disclosure systems that serve the same purpose as the taxonomy, or at the very least, ensure that any such systems are complementary to the GFT.

To exchange experiences with regulators in other jurisdictions and **share good practices, international fora** can help governance actors to build up the knowledge necessary to play their role in the implementation process.

→ **Create incentives for the market to adopt the GFT**

Governance actors should encourage the adoption of the taxonomy by working with tangible incentives. This could involve **tax incentives**, for instance, through a reduction in the capital gains tax for investments that align with the taxonomy's criteria. It should be mentioned, though, that tax reliefs carry the risk of undesirable distributional consequences and diminish the government's fiscal leeway.

Another approach includes the intentional creation of **reputational pressure** through the establishment of an online database by a public authority. On that website, potential investors and the

interested public would have convenient access to the reports of companies that disclose on the GFT, which could potentially lead to heightened public pressure on companies to embrace the GFT and start disclosing.

→ ***Establish a verification and certification system***

To increase consistency and credibility, South African authorities should drive the implementation of a **certification and verification system for reports on the GFT**. As part of a certification system, economic activities are certified against a standard or a label, here against the GFT. A verification system, on the other hand, intends to guarantee the accuracy and reliability of reported GFT-related information. In both cases, the system relies on external agents to conduct the analyses. The corresponding financial sector regulator should specifically focus on establishing rules that align with international standards, such as those from the International Capital Market Association (ICMA), the International Accounting Standards Board (IASB) and the International Sustainability Standard Board (ISSB).

Factor 2: Capacity constraints of users

Capacity is a constraining element concerning the adoption of the GFT. Financial institutions often fulfil multiple ESG reporting requirements, both voluntary internal frameworks and mandatory regulations, limiting the resources available for GFT-assessments. The GFT is perceived as a highly complex document whose application requires expertise and time. Ensuring that economic activities meet the "Do No Significant Harm" criteria included in the taxonomy poses a particular challenge for users. When investment chains are long and many parties are involved in the data collection, taxonomy assessments are especially burdensome. Experience with ESG-related disclosure requirements differs between financial institutions, with listed companies usually having the most experience.

→ ***Improve capacities through training and exchange***

Taxonomy adoption should be facilitated by **strengthening the capacity of actors** throughout the investment chain to collect and report the relevant data. This could be done by offering targeted trainings to specific user groups, potentially conducted (or financed) by the bilateral technical cooperation such as the GIZ, and development banks such as the Multilateral Development Banks. These trainings would include case studies providing examples of use of the taxonomy and practical methods for its implementation. Such training sessions could empower stakeholders with the knowledge and skills needed to navigate the GFT framework confidently and integrate its principles into their financial practices.

Facilitating exchange and dialogue among financial market participants and regulators is crucial to fostering the adoption of the GFT. Organising roundtables to discuss lessons learned from implementing the taxonomy within specific segments of the financial sector can enhance the sector's capacity to adopt the GFT effectively. Business associations could, in cooperation with financial sector associations, play a vital role in facilitating such roundtables, leveraging their expertise and networks. Additionally, appointing dedicated contact persons within regulatory agencies to oversee the taxonomy implementation process would improve communication and collaboration between taxonomy users and regulators.

→ ***Offer support for pilot implementation***

Implementing another **round of pilot cases** for the GFT would be another opportunity to build on the progress achieved in the initial phase. This new round should focus on generating published reports on GFT-alignment. Financial market participants could be incentivised to participate by offering them consultancy support in preparing their first disclosure reports. Successful pilot participants should then continue reporting without additional assistance in the following years. Recognising the significance of such initiatives,

international development cooperation actors should consider funding these pilots.

Factor 3: Lack of recognition of the GFT by the EU

Ensuring a high degree of interoperability among different sustainable finance taxonomies globally is essential to facilitating cross-border investments. Interoperability refers to the comparability and potential connectedness of these policy tools. Taxonomies should share similar sustainability objectives, easing the comparability of approaches and enhancing corresponding decision-making. Additionally, interoperability requires taxonomies to cover common economic sectors and activities, using comparable industrial classifications. Greater interoperability minimises transaction costs associated with managing multiple taxonomies in international capital markets, potentially increasing user-friendliness for international investors and ideally facilitating cross-border investment flows.

The GFT is very similar to the EU taxonomy. However, the EU has not legally recognised the South African GFT as equivalent. If this were to occur, where alignment of an asset with the GFT was demonstrated, no further assessment of an alignment with the EU taxonomy would be necessary.

→ EU to consider formal recognition

To improve the interoperability of the GFT with the EU taxonomy, a political process exploring a mutual recognition is needed. In this respect, this recommendation primarily refers to the EU, which should make a full recognition possible. Beyond the case of South Africa, it is important to define international rules that enable functioning interoperability.

Ideally, and taking a long-term perspective, the alignment of taxonomy outputs, such as disclosure requirements and reporting formats, simplifies the reporting process for businesses operating in multiple jurisdictions.

While achieving interoperability is essential, it is equally important to acknowledge that taxonomies must accommodate country-specific circumstances. These variations may include the nature and maturity of the capital markets in each jurisdiction and the availability of relevant data. Taxonomies should consider the specific industrial structures and associated economic activities present in each country, as well as the unique sustainability risks that may arise. Additionally, it should be noted that a taxonomy that aligns with additional policy tools and sustainable finance strategies within the very same jurisdiction is more likely to be effective and widely adopted. Striking a balance between achieving interoperability and acknowledging country-specific circumstances is crucial for jurisdictions that develop a taxonomy.

Factor 4: Consequences of fossil-fuel path dependency

A taxonomy can only help to redirect capital if sustainable investment opportunities exist. However, due to fossil-fuel path dependencies, the availability of green projects in South Africa that is perceived by market actors as bankable is limited.

The country's industry structure is still shaped by fossil industries and the corresponding so-called mineral energy complex. Nearly the entire energy supply (95% in 2021, cf. Ritchie & Rose, 2022) is provided by fossil fuels. Coal products contributed up to 11% of exports by value and comprised 5.4% of the national GDP (South African Revenue Service, 2019). The mining industry, which involves not only coal but also minerals for the world market such as copper, platinum, gold and diamonds, employs over 500,000 workers (Department of Statistics South Africa, 2019). Energy producer Eskom and chemical company Sasol are closely linked to South Africa's industrial history and are still of great importance for today's economy. Even if a large-scale industry protest has not materialised in the case of GFT, significant lobbying power influences the political field concerning the economic transformation. Trade unions, which are powerful societal actors, also maintain a critical position against far-reaching

restructuring processes that potentially threaten existing employment structures.

In the context of an industry reality shaped by non-sustainable activities, a central challenge for the GFT to gain momentum is the lack of bankable green projects and products. Even if investors have the general intention to channel capital into sustainable activities in line with the taxonomy, they report difficulties in identifying concrete projects within South Africa. The negative picture that taxonomy disclosure reports would currently, in most cases, convey reinforces the low motivation of market actors to report on the taxonomy.

→ ***Increase availability of green projects***

An active **industrial policy** is necessary to develop sustainable investment projects. For instance, **Development Finance Institutions** should provide capital for green early-stage and high-risk projects. The GFT might then help to direct investments to these projects at a later stage. The GFT could also be a helpful tool for development banks to monitor progress in greening their own portfolios.

Conclusion

The analysis of the South African case arrives at a sobering conclusion. So far, hardly any market actors use the GFT. Without policy changes and active measures by regulators, a gradual disappearance threatens the GFT. This policy brief has presented concrete recommendations for such measures.

The experiences in South Africa offer four lessons learnt for the implementation of sustainable finance taxonomies in general:

1) Regulators need clear governance and communication strategies: It is questionable whether a voluntary approach is sufficient to convince a critical mass of market participants. Regulators should thus consider enacting mandatory disclosure requirements associated with a taxonomy. A taxonomy implementation process needs clear responsibility on the regulatory side. National regulators

should form a working group to monitor the implementation and coordinate measures. Regulators or stock exchanges should require issuers of green bonds to use sustainable finance taxonomies to determine the eligibility of projects.

2) Market actors need to expand their capacity for taxonomy assessments: Market participants need to increase their capacity to conduct assessments of taxonomy alignment. Training and awareness raising within institutions is vital. Development cooperation actors can make a contribution in offering or financially supporting such training.

3) Governments need to support a conducive environment for green projects: The potential of taxonomies to contribute to a redirection of capital flows depends partly on the availability of green investment opportunities. An active industrial policy should be used to support the development of sustainable projects. Development banks should supply initial funding for risky green projects.

4) Governments need to insist on formal international recognition: A formal mutual recognition of taxonomies would reduce transaction costs. The EU should recognise taxonomies of other jurisdictions that meet certain conditions and communicate clearly under what conditions it is willing to do so.

Referring to the experience of South Africa, this policy brief has described how challenging the implementation process of sustainable finance taxonomies is. As policy-makers in many countries all over the world have recently decided to introduce a taxonomy, the recommendations made in this policy brief on how these challenges could be addressed are of high relevance.

Conclusive evidence on the impact of sustainable finance taxonomies on capital flows is still lacking. It is safe to claim, though, that sustainable finance taxonomies will only be successful if they are a part of a comprehensive policy package that addresses the financial sector but also, directly, the real economy. With respect to the financial

sector, instruments that aim to increase transparency on the sustainability impacts of investments, such as sustainable finance taxonomies, need to be combined with policies that push financial market participants to act on the transparency created. Mandatory transition plans can, for instance, be such an instrument (Dikau, Robins, Smoleńska, van 't Klooster, & Volz, 2022). In addition, the success of sustainable finance policies is also linked to policies that directly address the real economy. If financial market participants, see, for instance, credible steps in the direction of a high carbon price, incentives to

redirect investments from carbon-intensive to sustainable economic activities will arise.

While sustainable finance taxonomies are not a panacea for directing capital to sustainable investments, and only work effectively when used alongside other complementary policies, they nevertheless offer substantial potential. As every prospective lever for the transformation of our economies is valuable, this policy brief provides guidance for policy-makers on how to ensure a successful implementation of sustainable finance taxonomies.

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Sören Hilbrich is a researcher in the research programme “Transformation of economic and social systems” at the German Institute of Development and Sustainability (IDOS) in Bonn.

Email: soeren.hilbrich@idos-research.de

Dr Kathrin Berensmann is a senior researcher in the research programme “Transformation of economic and social systems” at the German Institute of Development and Sustainability (IDOS) in Bonn.

Email: kathrin.berensmann@idos-research.de

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