

Asian Hopes for Sustainable Finance Will Rest on More Credible Taxonomies

Accepting Gas Power Plants as Sustainable Investments Heightens Greenwash Risk

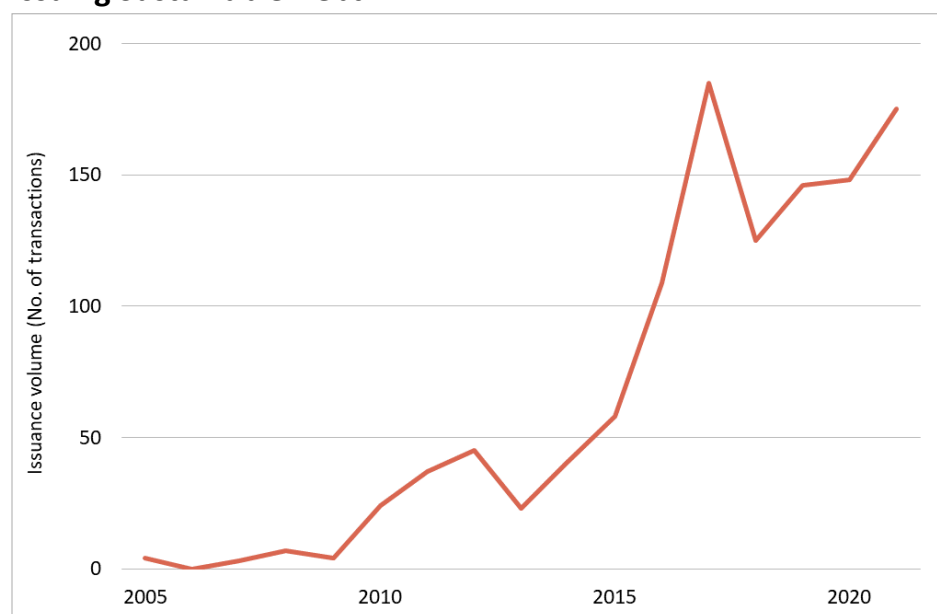
Executive Summary

The need for immediate and serious climate action that cuts greenhouse gas emissions more rapidly than the current trajectory is a very clear takeaway from the recently published Intergovernmental Panel on Climate Change (IPCC) report.¹

This will be particularly true for Asia's high carbon emission markets like China, Japan and South Korea, and for energy growth markets such as Indonesia, Vietnam and the Philippines.

One catalyst for the transition to reduce greenhouse gas emissions in power generation is the growing market for green and sustainability-linked loans and bonds in Asia's leading capital markets.

Figure 1: Asian Utility and Energy Companies Are Increasingly Issuing Sustainable Debt



Source: BNEF.

¹ IPCC. AR6 Climate Change 2021: The Physical Science Basis. August 2021.

Like their global counterparts, Asian policymakers have been rushing to encourage development of the policy pillars needed to kickstart green and sustainable bond markets in the region's capital markets.

The market is responding but given the lacklustre and inconsistent environmental, social and governance (ESG) reporting standards across the region, sustainable finance investors' concerns about the risks of corporate greenwashing are growing and could be a material barrier to market development.

Almost all company statements and reports globally—including about half of the statements from the energy sector—contain a high likelihood of misleading claims about a company's environmental awareness according to research led by Professor Andreas Hoepner at University College Dublin.² The problem can be exacerbated when hasty lenders and bond investors buy into the corporate rhetoric and fund them.

A robust sustainable finance market is significant to a cost-effective transition in Asia. Given this, enforcing higher disclosure standards to minimise misrepresentation will be a crucial market building block. At the same time, the development of more proactive policies deserves more attention. This is where sustainable finance taxonomies, if designed properly, should play a role.

**Robust sustainable
finance taxonomies
are a crucial market
building block.**

A taxonomy is a document that is usually binding, and which expresses factual and science-based views on the sustainability of an asset class. It specifies the technical requirements of an asset or project that companies must satisfy to enable the labelling of projects as green or sustainable.

Investors rely on taxonomies to determine what clean and sustainable assets the market needs to meet the objectives of the Paris Agreement while taking comfort they are deploying capital to real sustainable investments.

In theory, therefore, a taxonomy facilitates efficient capital allocation and supports the acceleration of a sustainable energy transition.

This matters particularly to ESG-focussed players in search of genuinely sustainable investment opportunities available through green and sustainability-linked bonds and loans. Business activities or assets that make their way into a green taxonomy are those that in theory would qualify for funding through these sustainable debt instruments.

² Bloomberg. [Using Artificial Intelligence to Sniff Out Corporate Greenwashers](#). August 11, 2021.

The State of Taxonomies and Where Asia Fits In

The problem with taxonomies and their usefulness is linked to their accuracy. Unfortunately for investors, this can be influenced by politics and lobbying.

Taxonomies have so far been published in several jurisdictions including China, the European Union (EU) and Malaysia. More of them are in preparation, including a regional framework for Southeast Asia that is expected to be endorsed by the region's finance ministers and central banks.

Most of the taxonomies to date share a common principle—that sustainable activity should “do no significant harm” (DNSH)—but differ in the planned use of the taxonomy, the process taken to develop it, and the criteria for what comprises a sustainable activity or asset.

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In June 2020, the EU published its science-based taxonomy (EU Taxonomy) which is viewed as a role model for other markets as it was intended to be a green-only taxonomy.

Since then, as a result of pressure from fossil fuel interests that would be threatened by an accelerated energy transition, the debate in the EU has shifted to a broader set of additional assets including gas-related projects that may be considered sustainable and added to the taxonomy. EU policymakers are seeking feedback from a wide range of stakeholders on a proposal to recognise within the EU Taxonomy economic activities that can result in a credible transition out of activities that are significantly harmful to the environment.³

Meanwhile, China from the outset took a different and controversial approach. China's first green taxonomy in 2015 recognised the marketing term “clean coal”, among others, as a green project that qualified for the issuance of green bonds, drawing widespread criticism. Recognising the importance of a credible green taxonomy, in 2021, the China Green Bond Endorsed Project Catalogue removed fossil fuel-related projects from the list and brought it closer to the EU Taxonomy.

Both the EU and China are working together and aim to harmonise their respective taxonomies by the end of 2021. This is a positive initiative between jurisdictions in response to investor requests for a globally consistent standard on green or sustainable projects.

Other taxonomies in the making, such as the ASEAN Taxonomy for Sustainable Finance, have been designed to prioritize an “orderly transitional pathway”.

³ Platform on Sustainable Finance. [Public Consultation Report on Taxonomy extension options linked to environmental objectives](#). July 2021.

Figure 2: Taxonomies Have Different Uses and Eligibility Criteria

Taxonomy	Approach on Eligibility	Usability	Other Comments
China’s Green Bond Endorsed Project Catalogue (2021 Edition)	Projects are considered eligible for green bonds if they meet the conditions set out in their respective descriptive explanation in the catalogue. Some projects refer to related national industrial standards, have simple quantitative requirements, and/or make a high-level mention of DNSH.	Used by financial, non-financial and state-owned enterprise borrowers to define green projects that are eligible for green bonds.	The 2015 edition categorised “clean coal” and “clean oil” as eligible green projects but were removed from the list in 2021. Nuclear energy is included. A “transition finance” standard is a possibility.
EU Taxonomy	The activity needs to substantially contribute to any one of the environmental objectives; DNSH to others; be conducted in compliance with minimum social safeguards; and comply with the Technical Screening Criteria which are introduced with delegated acts. Activities are categorised as “low carbon” and “transitional” for the climate change mitigation objective, and as enabling activities for all environmental objectives.	Used by large public companies and asset managers to disclose the taxonomy alignment level of their businesses and products. The EU Taxonomy will also be referred in official EU product labels such as the EU Green Bond Standard.	The EU Taxonomy refers extensively to the lifecycle assessment of activities, explicitly excludes solid fossil fuels. Extensions to the EU Taxonomy that classify activities into “no significant impact” and “significantly harmful” categories are being considered.
Malaysia’s Climate Change and Principle-based Taxonomy	Principle-based: key testing questions are used by financial institutions to classify their assets into categories related to climate transition. The level of climate-friendliness ranges from “climate supporting” to “transitioning” to “watchlist”. No exhaustive or illustrative list of activities provided.	Intended for use by financial institutions to classify the assets in their lending and investment portfolios, measure the climate-related risks and exposure, and report to the central bank, for internal risk management and supervisory purposes.	The testing questions for classification look at both transaction and issuer levels. It examines the positive environmental impacts at the transaction level and the negative environmental impacts and efforts to remedy and improve them at both transaction and issuer levels.
Bangladesh’s Sustainable Finance Policy for Banks and Financial Institutions	Mirrors the contents of the EU Taxonomy. Provides a list of eligible green products/projects/initiatives and two exclusion lists of economic activities considered ineligible for financing and sustainable finance respectively.	Used to encourage and supervise financial institutions to grant sustainable loans and conduct sustainable investments. The green list is also used as eligibility criteria for whether bank assets can be refinanced with the central bank under the Refinance Scheme for Green Finance.	

Taxonomy	Approach on Eligibility	Usability	Other Comments
Mongolian Green Taxonomy	Provides a list of activities considered as environmentally sustainable for investment purposes and does not provide technical criteria. Includes livelihood improvement as one of its overall objectives, adding a social element to the taxonomy.	Intended for defining green projects for a wider range of financial instruments, including loans, bonds, equity investment, insurance, etc. Beyond the eligibility of green financial products, it is also used for banks to report exposures and for the central bank to track the development of its green loan markets.	
Singapore's Green Finance Industry Taskforce Taxonomy (consultation stage)	Proposes to classify economic activity by specific numeric metrics and require compliance with the DNSH principle and minimum safeguards. The metrics could be consistent globally but the thresholds for the metrics could be region or country specific.	The consultation paper indicates that the taxonomy will be used by financial institutions to classify their portfolios and loan books. It is not evident whether it will be used for classification or fund disclosure.	Proposes a traffic light system, i.e., green, yellow and red, to address transition.

Source: International Capital Markets Association and respective official documents.

Based on IEEFA's analysis, most markets are likely to have taxonomies that expand beyond truly sustainable green investments.

As acknowledged in almost all of the taxonomies available, solar and wind power generation qualify as the greenest and most sustainable investments. This asset class will likely attract new pools of capital.

Sitting on the other end of the sustainability spectrum is coal power generation. Financing of coal plant expansions and refinancing existing operations do not qualify for sustainable debt. The "transitional" asset class is where controversial assets and investments, for example gas-powered generation, are most likely to be recognised.

Controversial assets and investments like gas-powered generation are most likely to be recognised in the "transitional" asset class.

Figure 3: High Carbon and Stranded Asset Risks Lurking in “Transitional Activities”

		Controversy Levels		
		Low		High
		Low Carbon	Transitional	High Carbon
Likely Projects	<ul style="list-style-type: none"> • Wind • Solar • Geothermal 		Gas	Coal
Likely Investors	<p>Global, impact-focused debt investors with sustainability as main driver</p> <p>Regional/domestic, conventional debt investors with financial returns as main driver</p>			

Source: IEEFA analysis.

Asia’s Taxonomy Conundrum

The issues debated in the EU—particularly around the role of gas in the sustainable finance market—are complex due to the diverse political and economic interests stemming from the industry, lenders, investors and regulators.

While most Asian taxonomies have yet to acknowledge these influences, the issues apply equally to Asian markets and will be as controversial going forward as the region contemplates replacing coal-fired generation with gas-fired power.

Recognising that high carbon emitters are beginning to struggle to raise capital from banks and debt markets, some Asian policymakers are exploring whether gas-powered generation could be credibly labelled as “transitional” or “transitioning” activities, and by extension be considered sustainable investments to provide access to new pools of capital.

Policymakers must rationalise the issues related to gas as a sustainable investment.

This poses a significant problem for ESG lenders, investors and policymakers. Taxonomies that classify high emission activities as “sustainable” would taint the asset class and discredit the taxonomy.

If Asian markets are hoping to meaningfully attract leading ESG investors and green the region's economy, policymakers must rationalise the issues related to gas as a sustainable investment.

Figure 4: Gas Power Assets Within Taxonomies

	Likely Asset Class	Likely to Include Gas Power Plants
China	Green	No
EU	Low carbon	No
	Transitional	Yes, if the project lifecycle carbon emission is <100gCO ₂ /kWh
Malaysia	Climate supporting	No
	Transitioning	Yes, if 'remedial actions' available
	Watchlist	Yes
Bangladesh	Green	No
Mongolia	Green	Yes, no thresholds
Singapore (Under Consultation)	Green	To be confirmed, consulted on the inclusion of abated gas
	Transitioning	

Source: IEEFA analysis from respective official documents.

Controversy Around Financing Gas Power Assets as Sustainable Investments

One of the reasons the oil and gas industry has defended the funding of gas-related projects under the sustainable label is that gas combustion is seen as cleaner than burning coal. Another reason used by the oil and gas industry is that Asian emerging and developing markets are currently more reliant on fossil fuels and for the time being, have a narrower investment pool of green projects. In Asia, this has led to an extended debate among energy policy planners about the merits of gas and LNG as a reasonable bridging fuel to greening the economy.

The oil and gas industry is ignoring the undisputable fact that gas is a fossil fuel.

The issue is that the oil and gas industry is ignoring the undisputable fact that gas is a fossil fuel that contributes carbon and methane to the atmosphere through its combustion, with lifecycle emissions that are dangerous and significant.⁴ Burning gas produces about half as much carbon dioxide (CO₂) as coal to produce the same

⁴ Climate Bonds Initiative. *EU Taxonomy Briefing: The Hidden Emissions from Gas-Fired Power*. February 2021.

amount of energy. However, burning gas releases methane, another greenhouse gas. Methane has a warming effect up to 80 or 90 times more powerful than CO₂ over a 20-year period, making gas worse for the climate than coal in the short term.

Gas emissions—like coal’s—do not equate to it being a sustainable asset. Any plans to massively expand the gas power industry, including using gas as a “bridge” could end up locking Asia into a high-emitting future.

In the EU, gas-powered generation is accepted as a transitional asset class under the sustainable label, provided that a project’s lifecycle carbon emissions are limited to 100g CO₂ per kilowatt hour (kWh). At this specification, gas power projects will likely require the use of a carbon capture-like technology, which leads to a second issue.

Betting On Carbon Abatement Technologies

One of the bigger challenges facing Asian markets is the question of whether carbon capture-like technologies could be the ‘saving grace’ for high carbon companies that choose to retain and have expansion plans for existing fossil fuel power plants. This is a particularly important issue as it has led to efforts to justify the addition of ‘abated assets and projects’ in Asian taxonomies, like the one proposed by Singapore’s green finance taskforce. Japan’s Basic Guidelines on Climate Transition Finance, although not an official taxonomy, also makes note of supporting such investments if they are credible and align with the Paris Agreement.

Carbon capture is yet to be proven as economically and technically viable, creating a credibility issue.

The problem, however, is that after more than a decade’s effort, carbon capture is yet to be proven as economically and technically viable at scale, which creates a credibility issue for labelling gas power plants as sustainable investments.

Based on IEEFA’s discussions with investors, the early stage of carbon capture’s evolution and the resulting risk of future release or leakage of sequestered carbon, for example, creates a possible future greenwashing risk which serious ESG investors are keen to avoid.

Even if carbon capture and storage were successfully implemented, serious green investors would likely continue to price in risks associated with these assets while seeking watertight regulation that goes beyond tokenism, such as mandating the use of carbon credits and imposing material penalties in the event of non-compliance.

How Does This Impact the Sustainable Debt Market?

Despite the eagerness to rationalise transitional assets like gas power plants as sustainable investments, it is worth noting that the existence of a sustainable finance taxonomy does not prevent projects that the taxonomy excludes from being financed through conventional sources of finance. They just would not be labelled sustainable investments or qualify for sustainable debt instruments.

It's hard not to assume then that the push for gas to be recognised as transitional or sustainable indicates that these carbon-intensive businesses believe they must fight for a place in the sustainable finance universe as investors shift their focus to the sustainability credentials of businesses in order to expand the sources of capital available to them. This would have implications for ESG-focussed investors who want certainty about avoiding greenwashing.

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A further complication arises when financial institutions, for example, lending banks that fund carbon-intensive transitional assets are green or sustainable bond issuers themselves. The proceeds from their green or sustainable bonds could be used to finance high-carbon assets if the taxonomy recognises them as sustainable investments. Under this scenario any such financial institution would also fail the ESG market test.

Given the direction of the global debate on taxonomies, it is likely that ESG investors will need to be even more forensic in their research on what the different taxonomies will recognise and, as a result, what issuers will sell as "sustainable". While it is still early to tell whether, under the sustainable label, transitional activities will be any more successful at attracting funds, the future of this asset class is likely to depend on existing pools of capital as many emissions-wary and dedicated green investors have been unwilling to hold these assets to avoid getting caught up in controversy. This is where additional due diligence on the borrower and thorough fundamental debt assessments will be required.

Conclusion

These issues speak to the ongoing challenge that investors may face as sustainable finance develops in Asia and for policymakers designing taxonomies. Emerging and developing markets in South and Southeast Asia will have the potential to compete for and unlock capital when institutional frameworks backed by taxonomies are robust and acceptable to global debt investors.

However, without clarity on the interests of ESG debt investors, whose capital will determine the usefulness of a taxonomy, there is little merit in diluting standards to accommodate all types of issuances or issuers.

If Asian policymakers and regulators want market development to proceed smoothly and taxonomies to be influential, now is the time to appreciate that industry is only one voice in market creation. It will be even more important to anticipate the rigour with which these investors are analysing assets and using taxonomies in the most dynamic global markets.

About IEEFA

The Institute for Energy Economics and Financial Analysis (IEEFA) examines issues related to energy markets, trends and policies. The Institute's mission is to accelerate the transition to a diverse, sustainable and profitable energy economy. www.ieefa.org

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