

Knowledge Brief

Green Taxonomies and MSME Finance: Implications for India's Financial System

Background

As countries accelerate their transition towards low-carbon and climate-resilient economies, governments, regulators, and financial systems are increasingly adopting green taxonomies, i.e., classification frameworks that define which economic activities qualify as environmentally sustainable. These taxonomies play a critical role in guiding capital toward climate-aligned investments while reducing the risks of greenwashing.

For emerging economies such as India, developing a national green taxonomy is particularly important. India has committed to achieving net-zero emissions by 2070 and strengthening its Nationally Determined Contributions (NDCs) under the Paris Agreement, including reducing emissions intensity and expanding non-fossil power capacity by 2030. India has already met key targets, such as 50% installed power capacity from non-fossil sources ahead of schedule, and is now moving toward updated commitments with a revised benchmark year of 2035 under the next NDC cycle (PIB, 2026). Achieving these targets will require an estimated US \$2.5 trillion in climate finance by 2030, and a whopping US \$22.7 trillion by 2070, necessitating strong frameworks that mobilize private capital at scale (GoI, 2025) (Niti Aayog, 2026).

Within this broader context, micro, small, and medium enterprises (MSMEs) represent both a challenge and an opportunity. MSMEs account for approximately 30% of India's GDP, 46% to India's exports, and employ over 250 million people, making them central to economic growth and industrial activity. However, they are also responsible for a significant share of industrial emissions due to outdated technologies, inefficient energy use, and limited access to clean technologies, making them a highly-emissions intensive sector (Niti Aayog, 2026).

At the same time, MSMEs face persistent barriers in accessing finance for technology upgrades and sustainability investments. This is largely due to structural constraints within the MSME ecosystem, including high upfront capital costs, limited collateral, weak credit histories, and information gaps, which limit their ability to access formal financing channels. As a result, smaller firms are often unable to adopt cleaner technologies or energy-efficient equipment, thereby slowing their participation in the green transition¹.

¹ Green transition is defined as a strategic shift towards sustainable, low-carbon and resource-efficient operations to enhance competitiveness, reduce energy costs and meet India's NDCs, as well as global emission standards (Niti Aayog, 2026).

Aligning MSME finance with green taxonomies could therefore play a crucial role in accelerating India's climate transition while supporting sustainable industrial growth. This brief explores the emerging global landscape of green taxonomies, including those in India, examines their implications for MSME financing, and identifies opportunities and challenges for financial institutions and policymakers.

Landscape of taxonomies

Green taxonomies have emerged as one of the most prominent regulatory tools in sustainable finance. This is a science-based classification system that adequately defines which economic activities are environmentally sustainable, according to a specific geography or region, acting as a guide for investors to identify 'green' investments. A lack of clarity in definitions has been identified as one of the many obstacles to scaling green finance by the 2016 G20 Study Group, which advanced the global dialogue on the green/sustainable taxonomy (World Bank, 2024).

Sustainable, green, and climate taxonomies operate at different levels within the broader sustainable finance architecture. Sustainable finance taxonomies represent the widest framework incorporating ESG considerations. Within this, green taxonomies focus specifically on environmentally sustainable economic activities. Climate finance taxonomies can be understood as narrower subsets of green taxonomies, focusing primarily on climate mitigation and adaptation objectives.

Globally, more than 50 green and/or sustainable finance taxonomies are either implemented or under development, reflecting the growing importance of standardized sustainability classifications in financial regulation (CBI, 2025). For emerging markets, these frameworks are particularly relevant because they help crowd-in international climate finance, as investors increasingly rely on taxonomy-aligned definitions to evaluate green investments.

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The European Union (EU) Taxonomy, introduced in 2021, has become the global benchmark for such frameworks, which has played a critical role in advancing the momentum for green finance flows (EC, 2024). It defines sustainable activities based on three core principles:

- Following the EU's lead, several countries have developed or are in the process of developing their own green taxonomies aligned with national priorities, such as China, South Africa, and Indonesia. More recently, jurisdictions including Thailand, Fiji, and Hong Kong, as well as regional initiatives such as the ASEAN Taxonomy for Sustainable Finance, have begun establishing similar classification frameworks. These frameworks serve multiple objectives:

Enhancing transparency and credibility in sustainable and green finance markets

Reducing greenwashing risks

Guiding public and private capital toward climate-aligned sectors

Supporting financial institutions in climate risk management

India's evolving climate finance taxonomy framework

India has begun developing its own climate finance taxonomy, with the first draft framework released by the Department of Economic Affairs in 2025, following announcements in the Union Budget (GoI, 2025). The taxonomy aims to establish clear criteria for identifying climate-aligned investments and directing financial flows towards sustainable sectors. The proposed framework focuses on the following key objectives:

- Supporting climate mitigation
- Strengthening climate adaptation and resilience
- Enabling transition pathways for hard-to-abate sectors
- Preventing greenwashing in financial markets

The taxonomy framework is expected to cover multiple sectors, including power and renewable energy, transport and mobility, buildings and urban infrastructure, agriculture and land use, and hard-to-abate industries such as steel and cement (GoI, 2025). India's approach is also likely to include transition pathways, allowing carbon-intensive sectors to qualify for green financing if they demonstrate credible decarbonization trajectories. This development, therefore, forms part of a broader sustainable finance ecosystem that includes:

Framework	Objective	Status
Framework for Sovereign Green Bonds	Guides the issuance of SGBs to fund public projects, accelerating India's transition to a low-carbon economy (DEA, 2022)	India has raised SGrBs totaling INR 477 billion, making India one of the 59 countries to have price-aligned sovereign GSS+ deals and the fourth-largest source among emerging markets (CBI, 2024)
RBI's Green Deposit Framework	Enables regulated entities to accept interest-bearing INR deposits specifically for financing eco-friendly projects like renewable energy, clean	Many Indian public and private sector banks offer green deposits through various schemes, such as SBI, Canara Bank, Bank of India, Bank of Baroda, HDFC Bank, and others. Banks have

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	transportation, and waste management (RBI, 2023)	also requested a reduction in the cash reserve ratio (CRR) held against these deposits to make it attractive for borrowers and banks alike (ET, 2026)
SEBI Business Responsibility and Sustainability Reporting (BRSR) framework	ESG disclosure framework mandating the top 1000 Indian listed companies to disclose on environmental, social, and governance (ESG) performance metrics since FY 2022-23	The BRSR Core framework in 2023 expanded disclosure requirements to include value chain reporting and third-party assurance for key ESG indicators (SEBI, 2023) (SEBI, 2024)
RBI Draft Disclosure Framework on Climate-related Financial Risks	Standardized framework for regulated entities to disclose climate-related financial risks aligned with global practices such as the Task Force on Climate-related Financial Disclosures, to improve transparency on climate risks, including governance, strategy, risk management, and metrics and targets (RBI, 2024)	The draft released in 2024 recommends phased implementation of climate-related disclosures for banks and FIs, including Scope 1, Scope 2, and eventually Scope 3 emissions. It also encourages scenario analysis and stress testing for climate risks (RBI, 2024)

Together, these measures aim to create an enabling financial architecture that supports India's long-term climate transition.

Implications of green finance taxonomies for MSME financing

As green finance taxonomies begin to influence financial decision-making, an important policy question concerns their implications for MSME financing. In many emerging economies, including India, MSMEs dominate industrial production and supply chains but often have limited access to formal finance and technical resources.

Given their scale and economic significance, the transition toward green product systems will necessarily involve the MSME sector by improving energy efficiency, adopting cleaner technologies, and reducing environmental impact. However, structural financing constraints and capacity limitations mean that smaller enterprises may face additional challenges in aligning with emerging sustainability standards.

Financing challenges faced by MSMEs in the green transition

Limited access to credit

- MSMEs often operate with limited collateral and shorter credit histories
- This leads to a higher perceived risk for lenders
- This constrains financing for technology upgrades or sustainability-related investments

High compliance and transaction costs

- Sustainability reporting and auditing requires technical expertise
- Emissions monitoring and certification create administrative burdens
- Therefore, green lending to MSMEs often appears

Low awareness of green finance options

- Many MSMEs lack information about available green financing instruments
- Nearly 3 in 4 MSMEs in India are unaware of green finance solutions
- Primary barrier is often a lack of information rather

Unclear definitions of 'green' activities

- MSMEs often undertake resource-efficient practices
- But these actions are rarely formally recognised in green finance frameworks
- This creates a disconnect between sustainability actions and financing access

Lack of standardised classifications

- Financial institutions rely on structural environmental criteria
- MSME activities do not often neatly fit existing green investment categories
- Many sustainable MSME activities remain invisible in

Taken together, these barriers create a situation in which MSMEs remain underrepresented in green finance flows. Addressing these challenges will therefore be critical for ensuring that sustainability frameworks such as green taxonomies do not inadvertently exclude smaller firms from the emerging landscape of climate finance.

How green finance taxonomies can support MSME access to sustainable finance

Green finance taxonomies can help address several of these barriers by providing clear, science-based criteria that define which economic activities qualify as environmentally sustainable. By establishing sector-specific thresholds and technical screening criteria, taxonomies reduce ambiguity for both borrowers and lenders. For financial institutions, this improves the ability to identify and classify green lending opportunities within MSME portfolios. For MSMEs, it provides greater clarity on the types of investments that are eligible for green finance, thereby improving access to financing instruments such as green loans, sustainability-linked loans and blended finance facilities (AFI, 2024).

Recognising these challenges, India's draft climate finance taxonomy incorporates an important guiding principle of **'proportionality – support for MSMEs'**. This principle acknowledges that smaller enterprises often lack the resources and technical capacity available to large corporates and therefore require simplified compliance mechanisms and supported policy frameworks. The draft framework emphasises that taxonomy implementation should avoid imposing disproportionate reporting or verification burdens on MSMEs while still enabling them to access sustainable finance (GoI, 2025).

In practice, this could translate into simplified eligibility criteria, phased reporting requirements and technical assistance programmes that help MSMEs align their investments with taxonomy-defined green activities. Such an approach is particularly important in the Indian context, where a large share of MSMEs operate within industrial clusters within limited financial and technical capabilities.

International experience suggests that well-designed taxonomies can play an important role in improving MSME access to green finance. For example, the ASEAN Taxonomy for Sustainable Finance, introduced in 2021 and updated subsequently, incorporates a **tiered classification framework** (aligned with the green and amber classification of activities) that allows financial institutions to progressively align lending activities with sustainability criteria while accounting for differences in data availability and institutional capacity across member countries (ACMF, 2025). This approach has supported banks in countries such as Indonesia and Thailand in **integrating sustainability criteria into SME lending programmes** focused on energy efficiency, renewable energy adoption and sustainable manufacturing practices.

Case study: Indonesia Taxonomy for Sustainable Finance

Under the Indonesia Taxonomy Sustainable Finance developed by the Financial Services Authority (OJK), financial institutions have begun identifying sectors where SMEs can access green financing (OJK, 2025). Banks have subsequently developed lending products targeting MSMEs investing in renewable energy installations, energy-efficient equipment and sustainable agricultural practices. Climate Policy Initiative along with the Bank Indonesia launched the Guidebook on Implementing Sustainable MSME Business Models: Mitigation action, providing a comprehensive and clearer roadmap for MSMEs, financial institutions and other key ecosystem players for identifying environmentally sustainable investments, thereby supporting the expansion of sustainable lending portfolios (CPI, 2026).

Beyond improving access to finance, taxonomy-aligned frameworks can also enable greater participation of MSMEs in green value chains. As larger corporations and multinational firms adopt net-zero commitments and sustainability targets, MSMEs within their supply chains increasingly face pressure to reduce emissions and adopt cleaner production practices. In India, where participation in global value chains accounts for over 40% of gross trade (in 2022), MSMEs play a critical role as suppliers to export-oriented industries and international markets, including the European Union (Niti Aayog, 2025). Access to taxonomy-aligned financing can help smaller firms invest in energy-efficient technologies, electrification of industrial processes, renewable energy generation and waste reduction systems, enabling them to remain competitive within evolving global supply chains (AFI, 2024).

Policy considerations for strengthening MSME participation in green finance through taxonomies

For India, ensuring that the emerging climate finance taxonomy effectively supports MSME participation will therefore be critical. By embedding proportionality principles, developing simplified compliance mechanisms, and aligning taxonomy criteria with MSME financing programmes, policymakers can leverage the taxonomy framework not only as a tool for directing climate finance, but also as a mechanism for accelerating the green transition of India's extensive MSME sector (Niti Aayog, 2026) (EU, 2023) (OECD, 2025) (UNFCCC, 2025).

Priority area	Recommendation	Intended outcome
Inclusive taxonomy design	Embed proportionality principles with the climate finance taxonomy, ensuring that compliance requirements are tailored to MSME capacities and do not	Improves accessibility of taxonomy frameworks for MSMEs and prevents exclusion from green finance flows

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	impose disproportionate reporting burdens	
Simplified compliance mechanisms	Develop simplified eligibility criteria, standardised templates and streamlined reporting processes for MSMEs to demonstrate alignment with taxonomy-defined activities	Reduced transaction costs and complexity, enabling wider adoption of green financing by firms
Integration with MSME financing programmes	Align taxonomy criteria with existing MSME credit schemes, industrial cluster initiatives and priority sector lending frameworks	Enables mainstreaming of green finance within existing financial channels rather than creating parallel systems
Capacity building and technical support	Support MSMEs through targeted technical assistance, awareness programmes and cluster-level interventions to identify and implement green investments	Strengthens MSME readiness and ability to access green finance
Financial sector alignment	Encourage financial institutions to integrate taxonomy criteria into lending practices and portfolio-level strategies, supported by risk sharing mechanisms and blended finance structures	Facilitates scaling of green MSME portfolios while managing perceived risks

Ensuring that India's emerging climate finance taxonomy effectively supports MSME participation will be critical to achieving both climate and development objectives. A well-designed and inclusive taxonomy framework can serve not only as a tool for directing climate finance but also as a mechanism for enabling a broad-based and equitable green transition, with MSMEs playing a central role in driving sustainable industrial growth.

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