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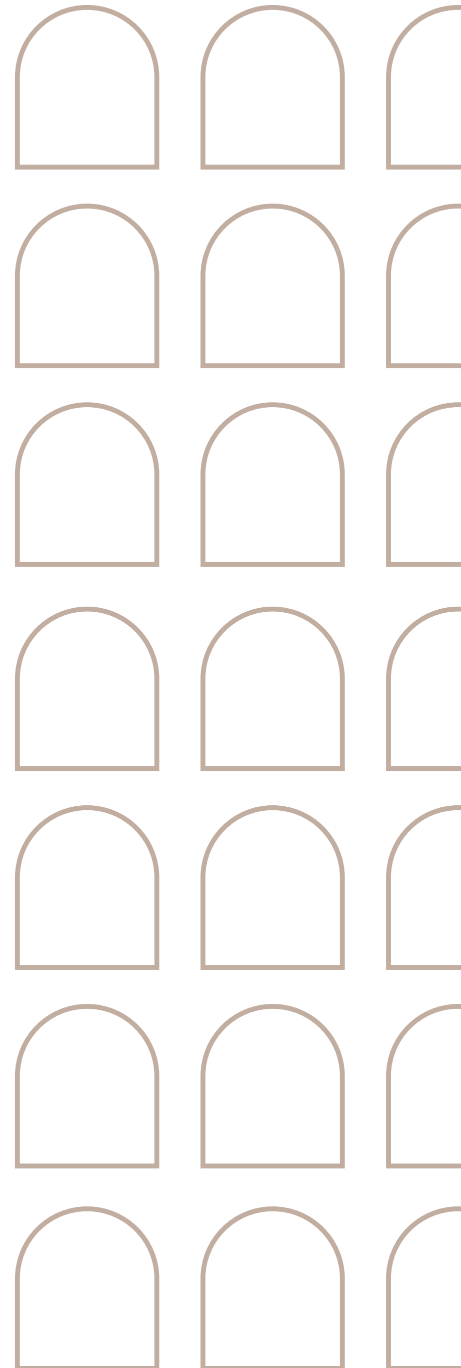

WILL THE EU SUSTAINABLE FINANCE RULES DELIVER?

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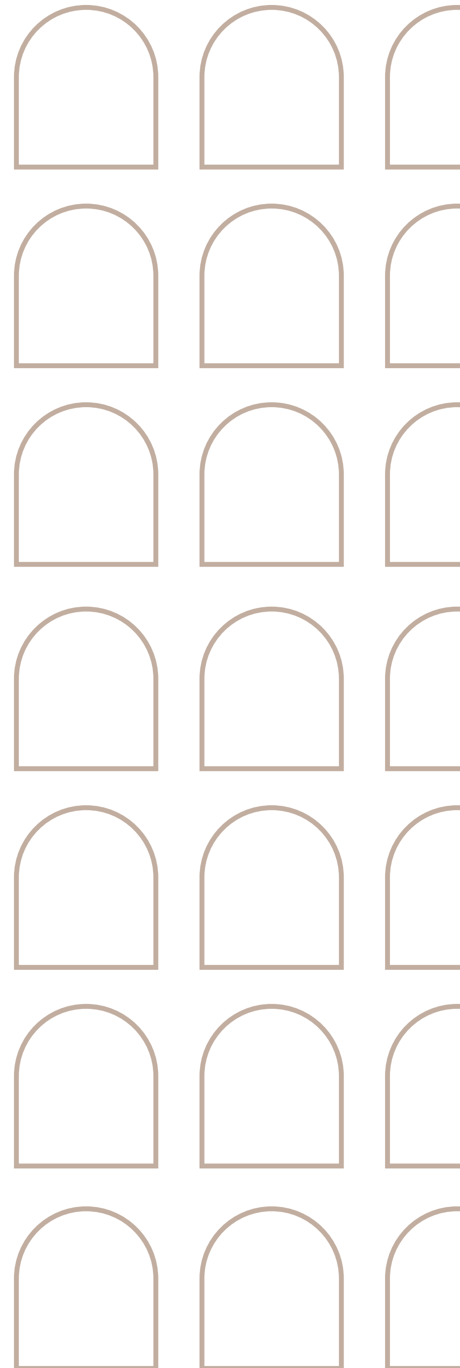

EXECUTIVE SUMMARY

In the last few years, the world has seen an unprecedented number of initiatives and actions in the field of sustainable finance. Around the globe, investors, regulators, and financial market participants are intent on changing the financial system to increase the volume of investments aligned with the Paris agreement, while increasing transparency on the impacts of their portfolios. The EU has been at the forefront of these efforts: it has created legally binding rules on non-financial risk disclosure, as well as a taxonomy of sustainable economic activities. The EU has been a first-mover in this space. The question is: will the new EU rules make a tangible difference? This policy brief deals with five questions on the expected impact of the new rules. It argues that the EU sustainable finance rules will lead to additional Paris-aligned investments on the back of a lower cost of capital for sustainable investments. These rules will have maximum impact if they are a part of a package of broader climate policies, including carbon pricing. Global coordination of sustainable finance rules would help, but it is not a prerequisite for success. The EU's learning by doing approach will provide valuable lessons to the finance world, especially on the metrics that make the impact of financial decisions transparent.

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The EUI School of Transnational Governance organised a High-Level Policy Dialogue in collaboration with the EIB in May 2021 with experts from the EIB and the financial sector to create more clarity on the expected impact of the new sustainable finance regulations. This paper highlights key conclusions drawn by the authors.

Views expressed in this publication reflect the opinion of individual authors and not those of the European University Institute.

1. THE NEW EU SUSTAINABLE FINANCE FRAMEWORK

The stated objectives of the EU sustainable finance rules are twofold: to reorient capital flows towards more sustainable investment opportunities and to limit 'greenwashing'. The EU has decided to develop sustainable finance disclosure and taxonomy into mandatory legislation. It is the first jurisdiction to enter this new field of reporting. This recently introduced legislation will start producing effects from 1 January 2022 onwards:

- The Taxonomy Regulation defines the types of economic activities that can be considered 'sustainable'. Sustainable economic activities have to substantially contribute to one of six environmental objectives,[1] do no significant harm to any of the other five, adhere to minimum social safeguards and comply with technical standards which are elaborated in a delegated act.
- The Sustainable Finance Disclosure Regulation (SFDR) addresses the question of how sustainable current investments are. It obliges financial market participants to be transparent about the sustainability risks of their investments and products. It introduces indicator-based communication and requires investments marketed as sustainable to prove alignment with the taxonomy in the pre-contractual documentation and annual reporting.[2] These requirements are applicable to all funds sold in the EU market (whether the investments are located within or outside the EU).The regulation came into force on 10 March 2021 and draft Regulatory Technical Standards have been elaborated by the European Supervisory Authorities.[3]
- A Corporate Sustainability Reporting Directive (CSRD) is currently being negotiated with the aim of replacing the current Non-Financial Information Disclosure Directive (NFRD). This Directive, when adopted, would oblige all corporates, not only those active in the financial sector, to report on sustainability risks and opportunities.

2. FIVE QUESTIONS ON THE IMPACT OF THE NEW EU SUSTAINABLE FINANCE RULES

2.1 Will the EU sustainable finance rules lead to an increase in the volume of sustainable investments?

Whereas it is quite clear how the new rules will bring transparency about the impacts of investments on climate change and other environmental objectives, the bigger question is whether they will lead to additional or increased number of sustainable investments. "Yes, of course", say those who believe that investments integrating Environment, Social and Governance (ESG) objectives beat the market in the longer term. "No", say those who think disclosure is becoming an indicator-chasing and box-ticking exercise, diverting attention away from genuine alignment with net zero objectives. However, both answers are too simplistic. The phenomenon of ESG stocks outperforming the average market return during the COVID-19 outbreak does not guarantee long-term capital reallocation to sustainable investments.[4] But dismissing the new regulations as window dressing is also inaccurate. How else will corporate net zero promises be checked, if not by obligations to be transparent about efforts and results? Improved transparency will inform shareholders as well as other stakeholders, enabling the latter to scrutinise it will also improve overall efficiency and will generate the trust that the transition towards a sustainable economy

1 Climate change mitigation, climate change adaptation, the sustainable use and protection of water and marine resources, the transition to a circular economy, pollution prevention and control, the protection and restoration of biodiversity and ecosystems.

2 The SFDR requires financial market participants to report on the Principal Adverse Impacts of their investments and to explain whether their products promote environmental or social characteristics (art 8, so-called 'light green' funds) or have sustainability as an objective (art.9, so-called 'dark green' funds).

3 The European Banking Authority (EBA), The European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pension Authority (EIOPA)

4 New research has also questioned the ESG alpha claim. See Bruno, G., Esakia, M. and Goltz, F., "Honey, I Shrunk the ESG Alpha": Risk-Adjusting ESG Portfolio Returns", April 2021

requires. Mandatory disclosure rules provide an instrument to strengthen shareholder power in favour of more transparency and ambitious corporate climate targets.[5] Moreover, transparency seems to be contagious, as competitors do not want to be seen as falling behind and to have to face uncomfortable questions.

We need additional, more subtle analysis. The new rules will lead to capital reallocation to more sustainable activities or projects if the balance of risks and costs is sustainably altered. Financial decisions, in particular those of a long-term character, need to be made with a strict assessment of risks and costs, which is where the new regulations should make a critical difference. They should provide relevant information to facilitate the factoring in of climate and transition risks and thereby affect the cost of capital. Transparent disclosure of risks and environmental impacts can correct the existing market bias towards 'brown' investments on the back of their long-standing, mature investment profiles as compared to new 'green' investments perceived as risky. Disclosure makes the myriad of fossil fuel industry risks more transparent, while making the allocation of capital to new and renewable energy easier.

Early evidence supports the importance of such improved risk and cost assessment, although the proof will have to be delivered in future investment decisions. Recent ECB research has shown that long-term risks can be substantial for a selected group of banks. At the same time, according to Bloomberg, sustainability-linked financing can make a difference of 0.5 to 1% in the cost of capital, which should be enough to kindle the interest of the Chief Financial Officers (CFOs). When disclosure rules about non-financial risks feed into financial calculations, there will be a lasting impact. In this respect, financial market participants should encourage companies they invest in to spell out their transition plans, with the option of making the cost of their finance dependent on achieving set climate targets. In case they would not be able to deliver on their self-imposed climate targets, companies could agree to a penalty that they are ready to pay on their loans, for example in the form of a higher interest rate.

2.2 Should climate come first in implementing the new rules?

The new rules are currently generating a massive capacity-building exercise amongst financial market participants. This policy implementation phase carries risks too. One of the lessons from EU climate policy, such as the EU Emissions Trading System (EU ETS), is that it is essential to have good data first. A lack of reliable and comparable data should not be allowed to discredit the whole disclosure framework. In this respect, it is to be recommended to start with the 'E', the environmental objective, and in particular, with greenhouse gas emissions, where monitoring, verification and reporting is most advanced. Many quantitative indicators and reliable empirical information are already available but need to be honed towards precise reporting formats by corporations. Reliable indicators on biodiversity, and tried and tested social ('S') and governance ('G') impact indicators seem to be some way off. The draft Regulatory Technical Standards by the European Supervisory Authorities recognises this in the suggested timing of implementation.

Moreover, climate investments are urgent because the trends are still so out of line with the goals of the Paris Agreement. The good news is that capital is currently being reallocated from fossil fuel sectors to investments in renewables. However, the total investment in energy infrastructure is down. The transition to a net zero energy system requires more investment, not less. For the world to be on a Paris-aligned investment path, the drop in fossil fuel investment needs to be more than compensated by investment in renewable energy. According to Goldman Sachs, annual capital expenditure investment in the energy

5 Eccles, R.G. and Klimenko, S., The Investor Revolution: Shareholders are getting serious about sustainability. Harvard Business Review, May-June 2019

system has been in the range of $1.5 to 2 trillion in the last decade. Achieving the most ambitious Paris Agreement goal of stabilising global warming at a 1.5°C would both increase this investment by some $1 trillion/year and require a re-allocation away from fossil fuels to the tune of $600-700 billion/year, according to the IPCC. These amounts are far from being achieved. Without dismissing the need to advance on other environmental and social indicators, it is important to prioritise the Paris Agreement mandate as an urgent starting point to reorient the capital flows.

2.3 Can sustainable finance rules have impact without carbon pricing?

In the long term, sustainable finance rules need to be supported by broader climate policy. The companies that are currently doing best in sustainable finance terms should also be the ones enjoying a competitive advantage in the market. The disclosure regulations push corporates to come up with robust transition plans and to be transparent about it. Without some form of carbon pricing or regulations, however, disclosure risks being a vain exercise. Sustainable financing will only continue to be generated when in synergy with or supported by regulatory activity in other sectors of the economy.

In that respect, the new sustainable finance rules can be useful in enhancing the credibility of the so-called Voluntary Carbon Markets (VCM), as highlighted in an earlier EUI Policy Brief. European companies declaring themselves carbon neutral, and using offsets for that purpose, will have to declare in full transparency where and how emissions reductions or removals have taken place. The fact that the EU has come forward with its mandatory sustainable finance disclosure rules may be a helpful tool for a market that so far is suffering from a pronounced lack of oversight and transparency.

2.4 Is global harmonisation a prerequisite for the EU sustainable finance rules to have the desired impact?

Financial market participants would prefer global rules to ensure comparability. According to a survey carried out by the Institute for International Finance, "65% of institutions said that 'green' regulatory market fragmentation was a big source of concern and would have a material impact on the market for sustainable finance." The Network for Greening the Financial System (NGFS)[6] called in its recent report on bridging the data gaps for common and consistent set of global disclosure rules, for a minimally accepted global taxonomy and well-defined decision-useful metrics. This begs the question: which rules and how minimal? A degree of realism and critical assessment is needed here.

First, regarding the rules, it is hard to see how the EU would change its rules for the purpose of global alignment, especially if that would mean weakening the EU's rules. This difficulty was expressed by Italian ECB Member of the Executive Board, Fabio Panetta in a blog post on a global accord for sustainable finance. He called for agreement on minimum standards, stating in the same breath that "the EU's approach – including the ongoing revision of the Corporate Sustainability Financial Reporting Directive – represents an advanced benchmark toward which any international standard should aim. Indeed, it would be beneficial if the rest of the world were to follow the EU's example and require similar legally binding disclosure. However, it is more likely that disclosure will become another file in the EU's climate diplomatic briefcase, together with the EU's proposed Carbon Border Adjustment Mechanism (CBAM).

There is a limited chance that the US will adopt the same wide-ranging sustainability concept and 'technical standards' approach as the EU has done. The Executive Order by US President Biden already narrows the scope to climate-related financial risk instead of the 'double materiality' (climate risk to the company and company risk to the climate), favoured by the EU. The next thing to watch is the exact climate-related disclosure rules Secretary of the Treasury Yellen will come up with as part of the implementation of the Executive Order. The Institute for International Finance (IIF)

6 NGFS, a network of central banks led by ECB director Frank Elderson

indicates in the above-mentioned report that 'some countries prefer a more principles-based approach, while others favour a more rules-based approach'. The US seems to be part of the first group, whereas the EU has chosen the latter.

Similarly, a minimal global taxonomy would most likely limit itself to a common language on Paris-aligned activities and principles (such as, 'do no significant harm'). As with disclosure, common agreement on the European science-based technical standards is unlikely. Even within the EU, this is proving contentious. While European businesses will emphasise the need for global alignment and minimal standards due to 'level playing field' concerns, European policymakers caution that it is not an option to wait for global harmonisation of methodologies. The exploratory talks between the EU and China in the International Platform for Sustainable Finance on some form of global consolidation around climate mitigation activities is a pragmatic first step.

2.5 Is a 'Brussels effect' to be expected?

In a recent blogpost, Anu Bradford, who originally coined the term "the Brussels effect", sees the new sustainable finance rules as a new manifestation of that effect. Whereas US and China might opt for a slightly different set of disclosure and taxonomy rules, they will need indicators and metrics on ESG as well. Here, the EU will provide valuable learning for all with regard to decision-useful metrics. The financial disclosure rules are already applicable to all funds sold on the European market, which also applies to global financial institutions. This is very similar to the applicability of Europe's carbon market for foreign-owned industrial activities established within the EU or for standards for imported goods sold on the European market. The fact that regulation in Europe includes both carbon pricing and technical standards offers a unique chance for maximising synergies contributing to the low-carbon and sustainable transition. If well executed, the EU will benefit from a first-mover advantage in the field of sustainable finance as well.

Some consider developing taxonomies as a prerequisite for consistent collection of data and comparable analysis based on these data.[7] Internationally, however, it might be easier to reach an agreement on metrics rather than on technical standards. From a 'learning-by-doing' viewpoint, the proliferation of data frameworks and methodologies of recent years may have already been beneficial in making data available and assessing the relevance of new data methodologies and techniques, thus perfecting our understanding of what data points are more meaningful or reliable and comparable. By moving first, the EU has the chance to shape and influence the development of metrics around the globe. Even if global coordination is preferable, the EU was right not to wait for harmonisation and to allow for learning-by-doing instead. Based on this EU experience, the focus should now start shifting from availability of data to more reliable, comparable and impact-linked data, also on a global level.

3. CONCLUSIONS

The EU is taking legislative initiatives in four areas to meet its Paris Agreement commitments: carbon pricing, technical performance standards, promotion of low-carbon technologies such as those for renewable energy, and transparency on climate and carbon risks. There are overlaps between the EU's legislative instruments, but what matters most is their combined coherence. Renewable energy is advantaged by massive support and by not having to bear the costs of carbon. Revenues from emissions trading are being deployed to facilitate industrial innovation. Taxonomy rules define sustainable technologies in terms of their carbon intensity. This approach combines market-orientated initiatives (EU ETS and financial disclosure rules) with technical standards (CO2 performance of passenger cars) and market creation for low-carbon technologies (renewable energy targets, including in transport).

Sustainable finance is important in this combination of instruments because it applies to private capital investments across all

7 Network for Greening the Financial System, Progress report on bridging the data gaps, May 2021

economic sectors. The financial investments needed for the climate transition are enormous, and the economic recovery initiatives following the COVID-19 epidemic further increase the funds with which to 'build-back better'. While time will be needed for these initiatives to make a difference, the EU is bravely readying itself for more ambitious action, requiring financial market participants to change behaviour and contribute to reorienting the capital flows. More forthcoming legal proposals will reinforce this to enable the EU to meet its ambitious climate targets for 2030 and 2050. However, this is just the beginning. Policies and regulation will keep changing and improving, creating increasing pressure on marker actors to improve their environmental performance and impact. The EU's Taxonomy regulation, SFDR and NFRD will all create a lively discussion amongst experts and various stakeholders about impact and next steps. Europe knows that time is short, and action across all economic sectors is what is needed. Investors and financial institutions, as everyone, now must play their part in the climate transition.

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The School offers Executive Training Seminars for experienced professionals and a Policy Leaders Fellowship for early- and mid-career innovators. The School also hosts expert Policy Dialogues and distinguished lectures from transnational leaders (to include the STG's Leaders Beyond the State series which recorded the experiences of former European Institution presidents, and the Giorgio La Pira Lecture series which focuses on building bridges between Africa and Europe). In September 2020, the School launched its Master-of-Arts in Transnational Governance (MTnG), which will educate and train a new breed of policy leader able to navigate the unprecedented issues our world will face during the next decade and beyond.

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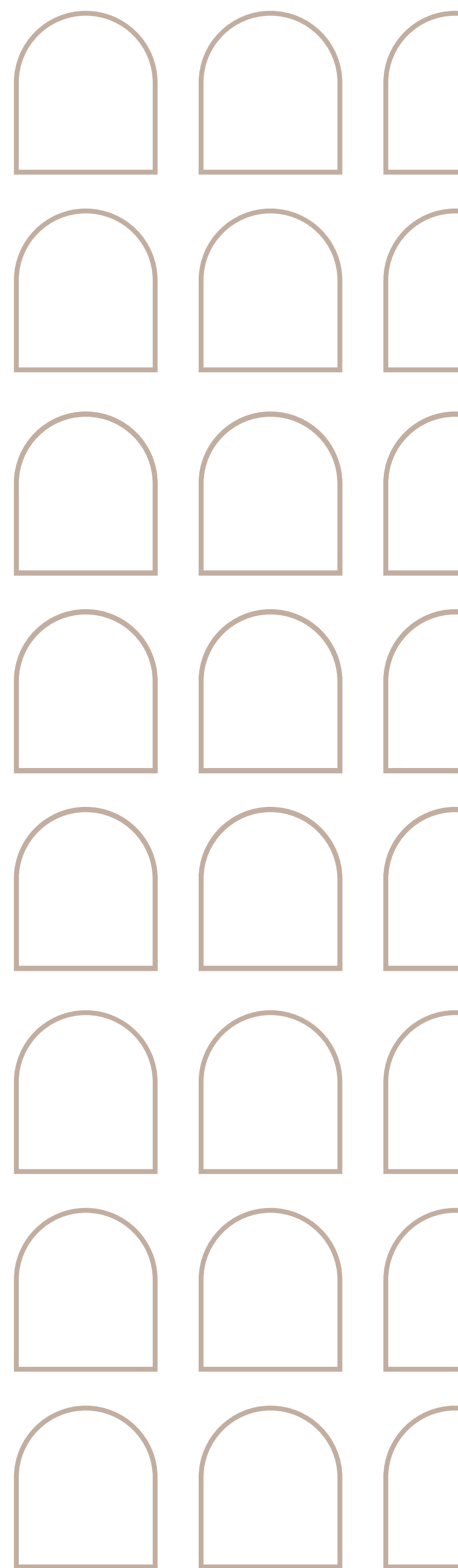

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