Strategy to finance the transition to a sustainable economy. International Bulletin of November 2021.

In a Communication addressed to the European Parliament, European Council, European Economic Social Committee and Committee of the Regions in December 2019, the European Commission (EC) presented its "European Green Deal" in response to the challenges caused by climate change and environmental degradation. This agreement specifically includes the main thrust of the growth strategy to be followed by the European Union with the aim of achieving climate neutrality by 2050.

The recently-adopted European Climate Law has also set an additional goal of reducing net greenhouse gas emissions by at least 55% by 2030 when compared to 1990 levels.

The achievement of these targets is of such importance that it means that the EU will have to make significant investments in all economic sectors. To this end it needs to have a financing framework in place to channel capital flows into investments that reduce exposure to climate and environmental risk. In the public sphere, the EU has agreed that a part of the budget for the 2021-2027 multiannual financial framework and the NextGenerationEU initiative will be allocated to projects related to climate change and which support biodiversity. However, public sector investments will not be enough. A significant sum will have to come from the private sector, for which capital markets will need to play a fundamental role.

The first action plan on financing sustainable development, adopted by the EC in 2018, was based on three main lines:

(1) A system for classifying sustainable activities (initially environmental but also with the possibility of covering social aspects in the future) that has been implemented through the Taxonomy Regulation adopted in June 2020.

(2) A disclosure framework for financial and non-financial companies in order to oblige them to provide sufficient information to allow investors to make informed sustainable investment decisions. It is important to note that the European approach to disclosure obligations is based on double materiality, which requires that the information to be provided covers the impact that a company's activities have on the environment and society and vice versa (the impact that a company's exposure to environmental and societal matters has on the risk it assumes and its profitability). Until now, two standards have been implemented as integral parts of this framework: (a) the Sustainable Finance Disclosure Regulation (SFDR) applicable to financial market participants offering investment products and financial advisors from 10 March 2021, and (b) the aforementioned Taxonomy Regulation applicable to financial markets participants and all companies that will be subject to the future Directive on the disclosure of corporate information on sustainability as of January 2022[1]. Commission Delegated Regulation (EU) 2017/565, which implements the Directive on markets in financial instruments (MiFID II), has been amended recently to include sustainability preferences in investment advice[2]. A similar change has also been made in the area of insurance.

(3) Investment instruments, such as the EU climate transition benchmarks or Paris-aligned benchmarks through a Regulation adopted in 2019 amending the Benchmarks Regulation, a proposal for a Regulation on European green bonds or the proposal to establish a label for financial products for retailers (due to be adopted in 2022).

Nevertheless, both the global context and the focus on the steps that need to be taken to achieve sustainability goals have evolved dramatically in recent years, prompting the EC to adopt a new phase in its sustainable finance strategy. This is based on six different courses of action – the framework for the financing required for the transition to a sustainable economy, inclusiveness, reinforcing the financial sector resilience, increasing the contribution of the financial sector, ensuring an orderly transition in the financial area and determining the level of global ambition.

The following are the initiatives that the EC has set itself in relation to each of the aforementioned reference

actions within the framework of its new strategy, published in July 2021.

Action 1. Develop a more comprehensive framework and help the financing of intermediary steps towards sustainability

The aim of this action is to provide approaches and policies that will allow economic actors to finance their plans for transition to achieve environmental and social sustainability objectives.

Concerning taxonomy, the EC initially focused on the development of technical criteria that allow consideration of when an economic activity contributes substantially to the achievement of environmental objectives – mitigation of the effects of and adaptation to climate change, the protection of water and marine resources, the transition to a circular economy, prevention of pollution and protection of biodiversity.

However, on the advice of the Platform on Sustainable Finance[3], this Communication stated its intention to expand the existing framework to include (1) certain economic activities, mainly in the energy sector, that contribute to reducing greenhouse gas emissions in a way that facilitates the transition this decade, (2) economic activities whose contribution to environmental objectives is considered intermediate (and not substantial), and (3) economic activities that do not have a significant impact on environmental sustainability and those that do not significantly harm environmental sustainability (report expected in late 2021).

Secondly, the EC will focus on the adoption of certain regulatory developments still pending within the framework of the Taxonomy Regulation, specifically (1) a delegated act on the technical screening criteria for economic activities that contribute substantially to the targets related to climate change that are not covered by the first delegated act on climate taxonomy, which will include activities such as agriculture, nuclear energy and natural gas (planned for this year), and (2) a second delegated act in which the technical screening criteria that determine when certain economic activities contribute substantially to the environmental objectives related to water, biodiversity, pollution and the circular economy will be developed (planned for the first half of 2022).

Thirdly, the EC intends to broaden the general framework for the labelling of financial instruments. In particular, it is looking to focus on (1) the labelling of transition bonds or bonds linked to sustainability (planned for 2022), (2) a general framework for the labelling of financial instruments that finance the transition of the economy (planned for 2023), (3) a possible "ESG benchmark" label, (4) the review of EU climate transition benchmarks or Paris-aligned benchmarks (planned before 31 December 2022), (5) minimum sustainability criteria for financial products that promote environmental or social characteristics, namely those from Article 8 of the Disclosure Regulation, and (6) amendments to the Prospectus Regulation to promote the transparency and comparability of securities that promote environmental, social and governance (ESG) characteristics (planned for 2022).

Action 2. Improve the inclusiveness of sustainable finance

The aim of this action is to facilitate the access of individuals and SMEs to sustainable financing, in particular by taking advantage of the opportunities offered by digital technologies.

EC initiatives will first focus on empowering retail investors, consumers and SMEs to access sustainable finance. To this end, and with regard to green loans and mortgages, the EC plans to (1) ask the European Banking Authority (EBA) for an opinion on a possible framework for granting these loans (scheduled for before the second quarter of 2022), (2) explore ways to promote energy-efficient mortgages (expected by late 2022), (3) launch an information campaign for these types of loans, and (4) support Member States through technical support instruments to provide advice on sustainable finance, for example on the use of green loans.

The EC will also promote financial education on sustainability by (1) reinforcing the experience and qualification of financial advisors, and (2) including aspects of sustainable financing in the framework of the financial competences to be developed jointly by the EU and the OECD for adults (expected by late 2021) and young people.

Finally, the EC will offer technical assistance to Member States to provide the advice required by SMEs on sustainability and access to sustainable financing with a reduced administrative burden (expected from 2023 onwards). Within the framework of the Directive on the disclosure of corporate information on sustainability, the European Financial Reporting Advisory Group (EFRAG) will implement a standard on the information on sustainability that SMEs may provide on a voluntary basis.

The EC will also focus on how to apply digital technologies to sustainable financing. Its specific intention is to integrate information on sustainable finance into the databases included in the European Data Strategy, for

example, the creation of a European single access point (ESAP), containing information on the sustainability of financial products in the European Securities and Markets Authority (ESMA) among other aspects, provided for within the framework of the Capital Markets Union. Together with the Digital Finance Platform, it will reflect on possible innovative solutions based on digital technologies that support SMEs and retail investors with regard to sustainability. It will also promote the development of zero emission data centres or, at least, low-emission data centres, evaluating the impact of certain digital financing technologies (for example, distributed ledger technologies for crypto-assets).

Thirdly, the EC will focus on how to achieve greater protection against climate risk, including the identification of insurance protection gaps through EIOPA's natural disaster dashboard and initiating a climate resilience dialogue with all significant stakeholders (planned for 2022).

Fourthly, the EC intends to increase its support for social investment. It intends to carry out a review of the indicators that refer to adverse incidents in the social and employment sphere, respect for human rights and the fight against corruption and bribery, in addition to those related to adverse incidents in the area of climate and the environment. All of these are included in the regulatory technical standards implementing the Disclosure Regulation (planned for before December 2022). On the advice of the Sustainable Finance Platform, it will also publish a report on a social taxonomy (expected at the end of 2021)[4] and present a normative proposal on sustainable corporate governance (expected in 2021).

Finally, in terms of green budgeting and risk distribution mechanisms, the EC intends to (1) strengthen the methodologies for monitoring spending on climate change and biodiversity (this institution already uses green budgeting tools in the EU annual budget cycle), (2) support Member States that want to redirect their national budget to green priorities (e.g. by increasing the use of green budgeting tools), and (3) organise an annual inaugural summit on sustainable investment prior to COP26.

Action 3. Enhance economic and financial resilience to sustainability risks

This action seeks to ensure that the financial sector is more resilient through an approach based on double materiality, given the material risks caused by climate change and environmental degradation, which may affect the stability of the financial system, while improving its contribution to sustainability.

To this end, the EC first plans to work on integrating sustainability risks into financial reporting standards, in association with EFRAG, ESMA and the International Accounting Standards Board (IASB).

The EC will then take steps to ensure ESG risks are consistently reflected in credit ratings and rating outlooks, while being transparently reported (expected in the first quarter of 2023). Prior to this, the EC expects to receive the ESMA assessment on the application of recently-updated guidelines to include ESG factors in credit ratings (expected in the third quarter of 2021) and a report on how credit rating agencies are incorporating ESG factors into their methodologies (expected no later than the second quarter of 2022).

The EC will then propose amendments to the Regulation and Directive on the capital requirements of credit institutions and investment firms to integrate ESG risks into their risk management systems (including stress tests to address long-term climate change), among other measures.

In the insurance sector, the EC will propose amendments to the Directive known as Solvency II that will include the incorporation of sustainability risks into the prudential framework of insurance companies (including the analysis of climate change scenarios).

It will also ask the EBA and EIOPA to study the possibility of a different prudential treatment for exposure related to assets and activities associated with environmental and social objectives in both sectors (expected in 2023).

Finally, the EC aims to strengthen long-term financial stability through (1) systematic monitoring of climate-related financial stability risks (by encouraging closer cooperation with significant European and national authorities), (2) the development of a methodological framework for possible financial risks associated with the loss of biological diversity and degradation of ecosystems, (3) the exercise of periodic stress tests by the European Supervisory Authorities and the European Central Bank, and (4) the evaluation of macroprudential tools, among other measures.

Action 4. Increase the contribution of the financial sector to sustainability

The aim of this action is to force financial institutions to incorporate the EU's sustainability objectives into their

long-term financing strategies and decision-making processes in order to achieve compliance with the commitments set out in the European Green Deal.

With regard to disclosure obligations, the aforementioned proposal for a directive on the disclosure of corporate information on sustainability and its corresponding regulatory implementation will first oblige large EU companies and listed companies (except for microenterprises), including financial institutions, to provide information on sustainability objectives and their transition and decarbonisation plans, as well as reporting on how they plan to reduce their environmental footprint. As mentioned above, the EC also intends to reinforce the obligations stemming from the disclosure regulation through a technical regulation standard that details the information that financial market participants have to provide on the decarbonisation action taken with regard to their financial products as well as with respect to the rest of their sustainable objectives.

Secondly, the EC will request EIOPA to assess the need to review the fiduciary obligations of pension funds in order to determine whether to expand the concept of long-term "best interest" of members and beneficiaries, integrating the concept of double materiality and adequately reflecting the sustainability preferences of members and beneficiaries in investment decision-making processes (planned for 2022). It will also reflect on the advisability of making further changes to the scope of UCITS, the Directive on alternative investment fund managers and MiFID II in relation to investors' sustainability preferences, as well as exploring how Directive II on shareholder rights can better reflect the EU's sustainability objectives.

Thirdly, the EC will take steps to improve the reliability and comparability of ESG ratings. It is specifically expected to launch a public consultation on the functioning of the market for these ratings (expected no later than the fourth quarter of 2021) and to adopt measures to promote their reliability and comparability (scheduled for the first quarter of 2023). It will also further assess certain aspects of the ESG research to decide whether intervention or action is necessary.

Action 5. Monitor an orderly transition and ensure the integrity of the EU financial system

This action seeks to guarantee the transparency and reliability of sustainability-related information to prevent greenwashing and the subsequent loss of investor or consumer confidence in sustainable financial products.

The EC is firmly committed to combating greenwashing. It will therefore assess whether the European Supervisory Authorities and the national competent authorities have appropriate supervisory powers to adopt the necessary measures. It will also determine whether or not these are being exercised correctly and if it is necessary to expand the type of measures to be implemented.

Secondly, the EC will develop a robust monitoring framework, which will include a series of indicators to measure capital flows into sustainable investments. It will also assist Member States to assess the adaptation of their financial markets to environmental objectives (scheduled for before June 2023), following an analysis of long-term investment needs by the EC. The ultimate aim here is to present a report on the state of the transition of financial markets in the EU, assessing the impact of the EU's sustainable financing agenda (expected by late 2023).

The EC then plans to strengthen cooperation between all significant authorities (including the relevant Member-State authorities, the European Central Bank, the European Systemic Risk Board, the European Supervisory Authorities and the European Environment Agency) with the aim of achieving a common approach in monitoring an orderly transition and ensuring that double materiality is consistently integrated throughout the EU financial system (planned for 2022).

Finally, the EC wants to strengthen sustainable financial research by establishing a Sustainable Finance Research Forum in order to foster knowledge exchange between researchers and the financial community.

Action 6. Set a high level of ambition in developing international sustainable finance initiatives and standards and to support EU partner countries

The aim of this action is to promote a broad international consensus on sustainable finance that ensures that the agreed objectives can be achieved, as well as providing support to EU partner countries.

Here the EC specifically intends to promote the adoption of double materiality, guaranteeing robust disclosure frameworks and common taxonomy objectives and principles. It also proposes that the Financial Stability Board broaden its mandate to cover the contribution of the financial system to environmental and climate objectives, ensuring that its approach encompasses double materiality.

It will seek to expand the work of the International Platform for Sustainable Finance to cover new topics, such as biodiversity and financing the transition, strengthening its governance and working towards greater collaboration with the public sector. This Platform plans to publish a report on a common taxonomy in the autumn of 2021, offering a comparison on the disclosure of information related to sustainability and its Annual report.

Finally, the EC will support low- and middle-income countries to scale up their access to sustainable finance by developing a comprehensive strategy and by promoting sustainability-related financial instruments through initiatives such as the European Fund for Sustainable Development Plus (EFSD+).

The Commission will report on the implementation of this Strategy by late 2023, supporting Member States in their sustainable finance efforts.

[1] As this Directive is still in the processing phase, until its application date – forecast for 2023- only companies that are subject to the current Directive on non-financial information will be initially required to comply with the Taxonomy Regulation.

[2] Along with this change, other amendments to the implementing rules (level 2) of the Directive on undertakings for collective investment in transferable securities (UCITS) and the Directive on alternative investment fund managers were published in August 2021, as well as other amendments regarding MiFID II, in order to integrate risk and sustainability factors into these systems.

[3] The Sustainable Finance Platform replaces the Technical Expert Group (TEG) on Sustainable Finance. Pursuant to Article 20 of the Taxonomy Regulation, it will advise the EC on the development and update of technical screening criteria, the review of these Regulations, the development of sustainable finance policies and the treatment of other sustainability objectives, including social aspects, among other functions.

[4] See article on this topic in the same edition of the International Bulletin.

Useful link:

COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS. Strategy for Financing the Transition to a Sustainable Economy