EU initiatives to facilitate the green transition financing in times of economic recovery

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Report

Jean-Pascal van Ypersele introduces the webinar. He recalls that the Sustainable Europe Investment Plan of the EU Green Deal has the ambition to mobilize at least EUR 1000 billion of private and public sustainable investments over the upcoming decade and that the EU leaders agreed on July 21 that at least 30% of the Recovery and Resilience Facility would be spent on sustainable and low-carbon investments. He adds that the renewed sustainable finance action plan of the EU Commission will play a central role for economic recovery. For example, the European Central Bank recommended to extend the taxonomy for green financial products to public investment, and the possible issuance of a green bond to fund the EU Recovery and Resilience Facility is being considered.

Introduction

Veerle Nuyts recalls Ursula von der Leyen's words during her State of the Union address: "this is the moment for Europe to lead the way from fragility towards a new vitality.To repair and recover now and to shape a better world for tomorrow." The Green Deal remains the EU's growth strategy. The Commission has enshrined the political commitment to climate neutrality by 2050 into law and proposed to increase the climate ambition for 2030 to a reduction of 55% from the 1990 GHG emission levels, leaving no one behind. The Renewed Sustainable Finance Strategy will provide policy tools to ensure that financial flows are directed to green investments and to avoid stranded assets. Indeed, the green transition will require massive investments. And the private sector is to play a lead role in this effort. According to Commission estimates, the cost of inaction would be higher.

The 2021-2027 EU budget is a motor for the green transition, with a key role for a new temporary instrument, Next Generation EU (NGEU). This instrument will allow the European Commission to borrow up to EUR 750 billion on the financial markets and to channel these funds to the Member States as grants and loans, with a clear commitment to climate mainstreaming. According to the Commission's estimate, NGEU could deliver 2% of additional GDP by 2024 and create 2 million jobs. It expresses European solidarity because financial support will be concentrated on the countries hardest hit and where the resilience needs are greatest. At the heart of the NGEU is the Recovery and Resilience Facility. To benefit from the facility, each Member State must establish its national recovery and resilience plan defining a coherent set of reforms and investments to be implemented by the summer of 2026. Assessment criteria of the plans include their contribution to the green and digital transitions. A minimum of 37% of country's expenditures in the plan should relate to climate and the remaining expenditures should respect the do no significant harm

to the climate and environmental oath of the Green Deal. NGEU offers a true opportunity for Member States and the Union therefore to accelerate the investments and reforms needed for the twin green and digital transition. National ownership will be a key prerequisite for the reforms and investments to be a lasting success. It will be crucial that Member States engage as soon as possible in a broad policy dialogue with all relevant stakeholders to prepare their recovery and resilience plans.The EU budget will also contribute to achieving climate objectives on the revenue side, with new common resources to repay Next Generation EU loans that leverage on climate policy, such as a new carbon border adjustment mechanism. The July Council agreement was a key step in the on-going process for the EU Recovery Plan to be effective as of 1 January next year.

Arnau Queralt-Bassa describes the effects of the COVID-19: non-essential businesses were shut down, citizens were ordered to greatly restrict their movements. This entailed unemployment, lost incomes, rising public and private debt, social-psychological problems and growing inequalities.

The response of the EU institutions to the crisis with the reinforced EU budget raises a couple of concerns:

- The span of the 30% spending target for climate is very wide. It may include expenditures spanning from agriculture subsidies to research and innovation funding.

- A new and more effective methodology for monitoring climate spending and its performance, and to report on it annually, should be developed

- The Taxonomy Regulation should be utilized to direct the billions of the EU's budget in the years to come. However, to make taxonomy successful we have to start working already now, we have to demonstrate its usability because there is actually no time to be wasted.

The magnitude of the crisis and the upcoming transition will require societal cooperation. Governements should consult with stakeholders to develop ideas on how to respond to the challenges of the crisis. Advisory councils – as gathered in the EEAC Network – will continue to fulfill their role in this process.

Science has a very important role to play as well. Instead budgets for Horizon Europe, the EU's next funding programme for research and innovation (2021-2027) were slashed during the negotiations in July. This is counterproductive and should be debated in the months to come.

The recovery from Covid19 must become an opportunity to steer Europe towards the much-needed sustainability transformation, leaving no one behind.

Part I: How to stimulate sustainable finance in Europe after the COVID-19 outbreak ? The Renewed sustainable finance strategy

Emmanuel Buttin took stock of the 2018 Action plan on sustainable finance. The EU is the first jurisdiction in the world to develop such an ambitious comprehensive framework for sustainable finance:

- The amendment to the benchmarks regulation published in December 2019 created two climate benchmarks to facilitate climate conscious investment strategies. These are very useful for passive investing and will thus be quite transformative.

- The disclosure regulation was adopted in November 2019. This regulation lays down transparency requirements at product and entity levels. It is also a very transformative tool with major implications for business models and marketing strategies of investors and asset managers. The European supervisory authorities will propose a delegated act to set up sustainability indicators by the end of this year. Despite some pressure to delay the entry into force of the regulation, the Commission maintains the planned deadline in March 2021 because it considers it as a key area of the 2018 Action plan.

- The Commission amended the delegated acts under the Markets in Financial Instruments Directive and the Insurance Distribution Directive to enable retail investors to reflect their sustainability preferences into their investment choices.

- The Taxonomy regulation aims at addressing the risk of greenwashing where individual entities can use their own definitions of a green investment, and also the risk of diverging definitions of green between the member states. Economic activities of the taxonomy 1° substantially contribute to one of the six environmental objectives (climate change mitigation, adaptation etc.°, 2° does not significantly harm the other environmental objectives, 3° complies with the technical screening criteria (metrics) and 4° is carried out in compliance with minimum social and human rights safeguards. This taxonomy is to be used by member states creating labels for environmentally sustainable financial products and by financial market participants selling such products. The taxonomy is very transformative because all the investments underlying such products do not have to comply with it. Financial market participants just have to disclose how and to what extent these investments do so. Large companies (more than 500 employees) must also report on the alignment of their activities with the taxonomy. A delegated act setting up the technical screening criteria for climate objectives will be adopted by 32 December 2020. The "platform on sustainable finance" will prepare the criteria for the other environmental objectives, for which delegated acts will be adopted by 31 December 2021.

- A consultation is ongoing on a green bond standard which could possibly be enshrined in a regulation. This standard could have a massive impact because the President of the Commission announced that 30% of the revenues of the Recovery and Resilience Facility would be raised as green bonds.

- The Commission is reviewing the Non-Financial Reporting Directive (NFRD). The existing reporting framework raises difficulties in terms of consistency of data, verification, etc. Current standards and practices for reporting need to be captured in a possible standard for non-financial reporting, and the European Financial Reporting Advisory Group (EFRAG) was mandated to start thinking about it.

Emmanuel Buttin then commented on the Renewed sustainable finance strategy announced in the Green Deal. The strategy for sustainable finance needs to be more ambitious, to further capture the real economy with its tools in order to match the climate neutrality objective by 2050 and the 55% emissions cut by 2030. The Commission does not see a trade-off between incentivizing a speed economic recovery and supporting sustainable transition. There are 3 main links between the recovery and the renewed sustainable finance strategy: 1° the need for better resilience of our societies towards climate and environmental risks, 2° the need for tools that can be used both by public and private entities, and 3° the need to accelerate the social dimensions of the sustainable finance agenda. The Platform for sustainable finance has to work on social issues. We need to expand the taxonomy regulation to social considerations.

The Renewed sustainable finance strategy will be published by the end of this year. It was the object of a public consultation. 20% of the 600 answers received came from citizens, which is not very common for a consultation on financial regulation.

The Platform for sustainable finance will also work on a possible brown taxonomy.

Part II – How to ensure efficient management accounting of businesses' total environmental impact ? EU support for standardized corporate green accounting practices

Thomas Verheye zoomed in on Natural Capital Accounting, which is mentioned in the Green Deal. The World Economic Forum Global Risks Reports indicates that the bulk of risks that are jeopardizing the economy is now composed of environmental risks. Climate has no monopoly on the disaster, which also relates to water, air, biodiversity, etc. All these risks are interlinked, and they are also linked with economic and social wellbeing. For managing environmental risks properly, we need to look at the risks combined, not separately. We need a total impact approach for adhering to the do no significant harm principle and to avoid shifting risks instead of mitigating them (ex: Diesel case).

The universal environmental management agenda looks at all these risks together and moves forward to the levels that are sustainable. It is important to mobilize the corporate sector and the economic decisionmakers with an agenda that is simple and consistent over time.

Sustainable finance is getting more popular but the share of investments that could be labelled with confidence as ESG compliant investments is only 2% of the market. We can no longer ignore

the footprint of the remaining 98% of investments. There are obstacles to sustainable finance: a poor understanding of environmental risks, a lack of harmonized metrics, poorly joined-up policies, a limited bankable investment pipeline, etc. We need to combine the reduction of the footprint, which is the physical side, with the transformation of the capital markets, where more and more investments go towards sustainable investments, that contribute to reducing the footprint in the future.

The 2018 Action plan for sustainable finance has 3 objectives: to reorient capital flows towards more sustainable investments, to mainstream sustainability in risk management and to foster transparency and long-termism. The capital flows aspect prevailed. We need to make sure we're going back to the risk management aspect. And the Green Deal will make it possible to move forward beyond climate.

Is it possible to tackle all the environmental impacts of a company in one go ? The table set up by the Kering Group monetizes its impacts on air pollution, GHG emissions, land use, waste, water consumption and water pollution in 5 tiers of the supply chain, and sums them up. It is a model of what we want to standardize. So it is not limited to climate, and the global impacts are taken into account. At present a project funded by the EU LIFE programme gathers 300 companies worldwide that have been experimenting this methodology. This work runs in parallel with the review of the Non-Financial Reporting Directive (NFRD). We're looking at strengthening the data supply that is going to be used for external reporting and disclosure.

Natural capital accounting focuses so far on companies but can apply to government projects as well.

Q & A

<u>Natural capital accounting expresses a business total environmental impact in monetary terms. Will this be for internal pricing only, or also for taxation systems of governements, aiming at lowering the total impacts of businesses ?</u>

Monetization is basically used to create a common unit of account so that we can put together the impact-related dependencies of companies on air, water, land and biodiversity. It is not an attempt to put a price on the environment. It is focused on informing internal decision makers about the impacts and dependency of their activity on the environment. If they understand this, they will take action. It is not a price in the sense of a taxation, but a system to get the right economic signals.

<u>How does natural capital accounting and non-financial reporting related to each other ? How are they complementary ?</u>

Natural capital accounting helps enterprises to report on their environmental risks according to the double materiality approach. But natural capital accounting is not meant to be legally binding. It is standardized good practice moving up, and there is going to be an overlap with non-financial

reporting. It also complements the taxonomy because the taxonomy does not give you an indication of your total environmental risks.

What does the "do no significant harm principle" mean in the taxonomy ?

It means that you can no longer look at one aspect of the environment, in isolation of the rest. You should always try to reduce your total footprint, not one aspect only.

Part III – How to improve disclosure by businesses and financial institutions on their social and environmental performance ?

Several issues related to the review of the Non-Financial Reporting Directive (NFRD) were discussed.

Yvonne Zwick highlighted the role of the German Sustainability Code even under a European mandatory non-financial reporting framework. The Code "translates" the regulation, it is a publicly available learning by doing platform. It should not be up to the courts to try to clarify what the content of such a regulation should be.

Michèle Lacroix explained the origins of the double materiality approach of non-financial risks and opportunities. The recommendations of the Task Force on Climate-Related Disclosures (TCFD) moved from pure financial risks to climate-related risks for financial stability. Those risks are called "outside-in" risks for the enterprises because they can affect their economic resilience, and the value of their investors portfolios. The EU Action Plan on Sustainable Finance extended the scope of non-financial risks to the "inside-out" impact of enterprises on the ecosystem and on other sustainability factors. Under the new Sustainable Finance Disclosure Regulations, Asset managers and other market participants will have to disclose the principal adverse impacts of their investments from this point of view.

However, it is difficult to completely disentangle these two categories of risks. Financial Supervisory Authorities initially focused on avoiding systemic risks. Today it is really important to address both outside in and inside-out effects. That's why the European Commission has mandated the European Financial Reporting Advisory Group (EFRAG) to produce preliminary work for a standard for non-financial reporting. Different stakeholders can then work together.

Under the German Sustainability Code, companies already report on these two kinds of risks. Yvonne Zwick noted that enterprises reporting on sustainability risks are eager to measure them for better managing them. In contrast, under a more conservative understanding of risks, measuring a risk and quantifying a target is already a risk, because it may happen that the target is not reached. She added that when a firm wants to see how it affects sustainability issues, it may

have to scrutinize its value chains networks on a global level, which is not the case when it is only concerned about how sustainability issues affect its business case.

According to Michèle Lacroix, the users of non-financial information are still more familiar with outside-in information because it is the closest to the time horizon of a business plan. But sustainability is a journey. Investors can decide to foster the transition to a low carbon economy, to have a positive impact. Then they do not only need information on non-financial risks, but also on non-financial opportunities. But for this, information should be available and users still tend to have more information on outside-in than on inside-out sustainability impacts.

The key challenge for the review of the NFRD is to foster the meaningfulness of non-financial information made available to its users: does it inform about an investee's effective non-financial risks and opportunities ? how does it complement an investee's financial KPIs ? does it match the user's investment risk appetite ?

Users of non-financial information also need comparable information, and this information should be compatible with the digital agenda of the EU. For this, reporting standards are needed, but it is very important that comparable information always remains meaningful for the companies disclosing it.

Yvonne Zwick suggests to look for "transformation indicators" which are really covering the interest of steering an issue within a company and delivering relevant information to financial market actors and analysts which would like to support sustainable business cases. This could also bring missing data for national reporting on Sustainable Development Goals (SDGs) thereby meeting Target 17 of the SDGs (Partnerships for the Goals).

According to Michèle Lacroix, the meaningfulness of non-financial information should be used as the main criterion to define the material scope of a reporting system, above the size of the enterprise. Small companies with meaningful non-financial impacts should also report on them. Yvonne Zwick indicates that like in most countries of the EU, SMEs are the backbone of the economy in Germany. Therefore, the sustainability code was designed to apply to them in order to create a broad movement towards sustainability in this country.

There is a need for an external verification of the information reported. Yvonne Zwick reports that the quality of non-financial data is currently pretty low, as companies are still learning and getting trained on how to report on sustainability aspects. This hinders the relevance of the information in analysis and rating systems because only credible data can become market relevant. Michèle Lacroix stresses that it is very important that any verified information remains material at company level.

The proposal for an EU mandatory Due Diligence Framework was also discussed. For Yvonne Zwick, this is more about a process to gather companies, to tell them how they can start the journey towards sustainability. The regulation should clearly set up the target, but leave a certain

liberty to companies, depending on how fast they will be able to fulfill the target, because it is a vast learning process. Regulatory requirements should be very close to the companies situations.

To conclude, Yvonne Zwick said that improved non-financial disclosure was all about acceptance and impact. Michèle Lacroix repeated that non-financial reporting has to be based on materiality assessment. It has to become mainstream over the next years, and the quicker, the better.

Discussion: What reforms are needed to make financial flows consistent with the SDGs ?

For **Sirpa Pietikäinen**, the combination of economics, finance and sustainability is the biggest challenge in finance, markets and economics since the innovations of accounting. The logic of sustainable finance would need to be copied in the whole of finance, regulation and public finance. The International Financial Reporting Standards (IFRS) should be the bigger home for this. The European taxonomy is just a baby step. We need an accounting system for natural resources consumption along the entire lifecycle of products. CO2 emissions, biodiversity, natural capital, indirect land use and energy consumption should be accounted for as well. The same goes for the social dimension (diversity, salaries, good treatment of people) and for governance (taxation, bribery etc.). The taxonomy somehow better defines the green side but should have this full set of indicators and life cycle analysis. It should maybe be part of the Eurostat classification in the longer run because it should be used both on the public and on the private sides. Then we would need to expand the taxonomy to the whole spectrum of activities: what is in-between, not so green, not so grey ? Do No Significant Harm should also be integrated in the accounting. This is how the risk would be calculated in accounting for a company or for a financial unit.

There is a triple materiality of risks. The first materiality is about the technological and financial risks of investments. The second relates to the effects of climate change, for example: what happens to food supply if the sellers are flooded ? And the third is that we should very clearly calculate the impact of climate change or biodiversity loss on our costs, this is an economic risk, and should be calculated in all phases of economic activities. So you are in a risky business if you invest in shale gas for example. This should be reflected in risk assessments for lending and capital requirements. Rating agencies and companies, but also member states should use this triple materiality. It should also be integrated in financial regulation (MiFID, Pensions regulations etc.).

The revision of the Non-Financial Reporting Directive is the next big issue. The right place for the reform would be the Accounting Directive itself because non-financial reporting should be part of an integrated company reporting. This should be public information in a template openly

accessible for investors, and everybody could compare. The problem right now is that we have 250 different kinds of rating systems, and the information reported is totally uncomparable.

The acute battle is then how it is integrated in public funding, for example in the European Semester looking at the member states budgets. Non-financial indicators are macroeconomic indicators. And then they would be matched with the taxonomy. Today, the agriculture sector calculates its impacts on climate differently than other sectors ! Now we have the huge amount of recovery and resilience funds. Not a single euro should be given for fossil fuels and the whole of the money should do no significant harm. At least 30% and 50% in her proposal, should go for green sustainable investment. So we can turn the economy around. If we don't do that, we will not only create huge debt problems but also huge climate problems that we are going to be suffocated with after 10 years.

Philippe Lamberts said a few words about public sector financial flows. The EUR 750 billion recovery plan is not a massive investment plan, but an interesting one. Whether we are going to align this plan, the national plans and national spending in general on the SDGs is a matter of political will. There is a reason to be concerned when we look at past performances of public funding (eg. support to fossil fuel power stations).

Under the previous European Commissions, environmental issues were a side-show at best. There is a difference with the new Commission. The European Green Deal is not a fake. But it is still having big gaps. The Common Agricultural Policy for example, which is a massive chunk of EU spending, is still not aligned with the Green Deal. But we can decide to change and that is just at the discretion of policymakers. Philippe Lamberts would question that there is a real will to go that far, even if there is an evolution.

There is a majority in the Parliament and in the Council for using at least 30% of the spending for climate. The Commission proposed to allocate 37% of the Recovery and Resilience Facility to climate but with the average of 30% of the total expenses, we don't need to do more than 25% with the regular budget. The European Parliament does not agree with that.

The European Court of Auditors found out that the Commission's way of accounting for climate-related spending is not satisfactory. So even a larger share of climate expenditure would not be relevant as long as we don't measure it properly. The Commission should adopt the EIB way of measuring climate spending, which is more reliable. This is also a matter of political will. Political will is also an issue in Belgium. Belgium is a laggard in Europe for climate and the SDGs. Business in Belgium has not been very forthcoming and the current Flemish government will not support the next Federal government if it wants to go in that direction.

As far as private finance is concerned, we are working as if we should incentivize the private sector to do the right things. But it is important to bear in mind that the only measurement that really matters for a listed company is EBITDA (Earnings before interests, taxes, depreciation, amortization). So if we are to drive the activities of the private sector, the first possibility to consider is law, not in terms of regulating the financial sector but in terms of authorizing or

prohibiting activities. This will drive investment in the private sector simply because things will be forbidden. The financial sector is asking for incentives and subsidies, but this is not the first thing to do, unless we believe that market mechanisms do the right thing, which is not true because the goal of the market is to maximize profit over a really short time horizon, it is not the common good. Unless for privately held companies where the majority of shareholders are stable shareholders. Regulation is absolutely crucial. We need binding and ambitious climate and biodiversity resource consumption targets and certain types of activities should be prohibited.

In the field of financial regulation, the taxonomy is a step in the right direction, but today it is both overstated and underused. It is overstated it because it is not mandatory. Financial market participants can sell financial products as “green” by simply disclosing how and to what extent the products underlying investments are in activities of the taxonomy. It is underused because the financial industry is more interested in selling more taxonomy-compliant products than in using it – as it is - to transform the real economy. So there is a strong pressure to relax the taxonomy by expanding it to “green” nuclear, “green” gas, “green” diesel.

Philippe Lamberts would like the taxonomy to drive not only the recovery funds, but also state aid. The member states poured money towards companies in difficulties, but there was very little in terms of green conditionality.

When it comes to influencing investors to invest in “green”, the problem is that they want a certainty of return and zero risk. If there is a risk, they want the taxpayer to cover the risk for them. On top of that, they ask for subsidies if asked to direct their financial flows towards green. But there is another way to do this, simply by putting the real price on non-green investments. Instead of spending public money to incentivize the companies to do green, we should simply penalize them if they continue to invest in activities that harm the common good.

Sirpa Pietikäinen doesn’t share Philippe Lamberts’opinion about private companies. According to her, financial companies in particular are more progressive than most members of the European Parliament and member states in the Council. She fully agrees with the need to ban more polluting activities by law. But she notes that this is politically unacceptable. So we should try to use the financial machinery to reach the objective.

Q & A

The European Central Bank recommends to use the taxonomy for assessing public expenditures, to guide investment priorities of the European Semester. Would this require also a social taxonomy, a brown taxonomy, or can it then be used as such ?

Sirpa Pietikäinen

The taxonomy can be used both for private and public investments, and it needs to because companies benefit from private, but also public investments. We cannot have two different accounting systems ! But the taxonomy needs to be developed further to integrate life-cycle analysis, to capture the whole spectrum of information, to quantify the impacts. And it should be

integrated in the Eurostat classification. But it is not yet there. The spendings for the Common Agricultural Policy are an important issue.

Philippe Lamberts is not convinced that a social taxonomy is indispensable. Social rights are mostly threatened by free trade agreements. Even if we adopt the best rules inside, our companies can be “punished” by market competition when products from countries which do not respect social rights can access the internal market. Market access from the outside should just not be allowed. Free trade agreements are also the “blind angle” of the European Green Deal.

<u>Tax compliance as a component of due diligence is very important in the context of the recovery because it can be said that recovery funds to help companies are funded by the taxpayer</u>

Sirpa Pietikäinen reports that the Commission’s President promised to take some steps concerning the tax matters.

<u>How to foster investors confidence in financial products compliance with “do no significant harm” in social and governance matters ?</u>

Sirpa Pietikäinen is not very much in favour of relying only on lists, because we always leave out something. It is always very complex, so the DNSH principle needs to be included in all parts of the taxonomy. This is very complex, but it is already in there when we look at the voluntary reporting initiatives in the private sector. The problem is that there are no metadata. Companies report different types of information, so it is not possible to compare it and we have no transparency.

It is also very important to have a very close act on the delegated acts that are being prepared by the European Supervisory Authorities to define the adverse sustainability impacts. The first version of the delegated act on climate and environmental impacts said that “fossil” meant “solid fossil”. So, gas and oil were excluded from the list, which is totally against science and everyday common sense.

Further questions asked by the audience

<u>Could the EMAS (Eco-Management and Audit Scheme) regulation be used in the context of sustainable finance ?</u>

<u>What is the link with the extended human rights Due Diligence legislation under construction in the EU ?</u>

<u>How to make all these sustainable finance initiatives relevant for the small business environment, which is very important in the EU economy ? And for initiatives such as New B, the enw cooperative bank in Belgium ?</u>