Sustainable Finance in the EU

Edited by

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The European Union and the Sustainable Finance agenda

Between ambition and reality

Pierre-Henri Conac

A. Introduction

Since 2018 the European Union (EU) has taken the lead globally in the field of sustainable finance. It has introduced or already adopted very ambitious initiatives and introduced legislative proposals at an incredible pace.

These legislative developments have already had a strong impact on the Member States because EU financial legislation is very precise and granular. By acting so quickly, the EU has positioned itself at the forefront of international developments. It should be noted that the United States (US) lagged behind because of former President Donald Trump's scepticism regarding climate change. However, since the election of Joe Biden in 2020, the US has begun to catch up but differences remain. For instance, on 21 March 2022, the US Securities and Exchange Commission (SEC) published a proposal on "The Enhancement and Standardization of Climate-Related Disclosures for Investors".[1] However, the SEC only focuses on the financial impact on issuers of climate change rather than on sustainable finance. This is due to the fact that its mandate is limited to investor protection. The promotion of sustainable finance is a political decision that the SEC cannot take on its own, unlike the European Commission (EC), which is a political body.

There is a legal basis for sustainable finance in the European Treaties. Article 3(5) of the Treaty of the European Union (TEU) states that

> "(The EU) shall contribute to peace, security, the sustainable development of the Earth, solidarity and mutual respect among peoples, free and fair trade, eradication of poverty and the protection of human rights, in particular the rights of the child, as well as to the strict observance and the development of international law, including respect for the principles of the United Nations Charter".

[1] Securities and Exchange Commission 17 CFR 210, 229, 232, 239, and 249 [Release Nos. 33–11042; 34–94478; File No. S7-10-22] RIN 3235-AM87, The Enhancement and Standardization of Climate-Related Disclosures for Investors, 21 March 2021.

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This provision was originally introduced when the Treaty of Lisbon came into force in 2007. In addition, Article 11 of the Treaty of the Functioning of the European Union (TFEU) holds that

> "Environmental protection requirements must be integrated into the definition and implementation of the Union policies and activities, in particular with a view to promoting sustainable development".

This provision was originally introduced by the Treaty of Amsterdam of 1997.

The EC adopted the first capital markets union (CMU) plan in 2015. In 2018, a High-Level Expert Group on Sustainable Finance published a report on this issue. It aimed at improving the contribution of finance to sustainable and inclusive growth by funding society's long-term needs. In order to achieve this goal, the report advised incorporating environmental, social and governance (ESG) factors into investment decision-making. Sustainability and ESG are two different concepts since sustainability is a wider concept.

As a follow-up, in 2018, the EC published a Sustainable Finance Action Plan (SFAP) to establish a sustainable finance policy.[2] It referred to the Paris Climate Agreement of 2015 and the United Nations (UN) "2030 Agenda for Sustainable Development", also adopted in 2015. The UN Sustainable Development Goals must cover the three pillars of sustainability: (1) environmental, (2) social and (3) economic/governance. They aim at improving the contribution of finance to sustainable and inclusive growth by incorporating ESG factors into investment decision-making.

The EC set out the "European Green Deal" on 11 December 2019 which underlined the need to better direct financial and capital flows towards "green" investments.[3] The Commission adopted the goal for the EU to reduce net greenhouse gas emissions by 55 % by 2030 compared with 1990 levels. It also aimed to achieve a climate neutral economy by 2050 and to be the first climate-neutral continent. The adoption of the European Green Deal in 2019 led to rapid policy changes. For instance, the EU adopted in 2020 a European Green Deal Investment Plan (EGDIP) designed to support sustainable investments over the next decade through the EU budget and associated instruments (eg InvestEU), to create an enabling framework for private investors and the public sector to facilitate sustainable investments and to provide support to public administrations and project promoters in identifying, structuring and executing sustainable projects. Following on from its 2018 Action Plan, the Commission published a

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[2] Communication from the Commission 'Action Plan: Financing Sustainable Growth', COM(2018) 97 final, 8 March 2018.

[3] Communication from Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions, The European Green Deal, COM/2019/640 final, 11 December 2019.

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Also, the SFDR does not include the concept of "Substantial contribution to environmental objectives" whereas both include the concept of "contribution to environmental objectives" which leads to complexities.

There are also inconsistencies between SFDR and MiFID II. As noted again by the SMSG

"Although article 8 products promote environmental or social characteristics, it is not required that they: (a) have a minimum percentage taxonomy aligned investments, (b) have a minimum percentage of sustainable investments in terms of SFDR or (c) consider PAI. Hence, it is possible that they are not eligible for meeting sustainability preferences as defined under MiFID."[40]

Finally, on a more general level, tensions exist between the environmental and social objectives. The EU legislative framework does not explain how to address them.

The desire of the EU legislator to promote sustainable finance at such a rapid pace might also lead to the issue of a lack of sufficient available investments. This regulatory complexity creates the risk of "green-bleaching" by which fund managers invest in sustainable activities but refrain from claiming to do so to avoid the risk of being accused of "greenwashing" if there are issues with their interpretation of the EU legislation. Greenwashing can be defined as the intentional or unintentional exploitation of policy priorities for communication purposes by reporting companies or investment firms or banks, without really aligning with the goals and expectations of these initiatives.

Commission Delegated Regulation (EU) 2021/1253 of 21 April 2021 implicitly admits this risk of scarcity of sustainable investment when it amended article 54 (10) of the Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms, since it organises the process for "returning" to non-sustainable investments.[41] A possible result of this scarcity of available investments and the risk of being blocked in the "sustainable finance" might be that investors do not opt in to sustainability preferences in the first place.

A final issue is the profitability of ESG investments compared to classic investments. There is no clear answer yet to this question since academic studies have yielded various and sometimes opposite results. However, the scarcity of sustainable investments, made even worse by the regulatory risks attached to "greenwashing", imply that only few will qualify as sustainable creating the risk

[40] SMSG, Advice to ESMA, SMSG advice to the ESMA Consultation Paper on Guidelines on certain aspects of the MiFID II suitability requirements, 3 May 2022 ESMA22-106-4032.

[41] Commission Delegated Regulation (EU) 2021/1269 of 21 April 2021 amending Delegated Directive (EU) 2017/593 as regards the integration of sustainability factors into the product governance obligations, OJ EU L 277/137, 2 August 2021.

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of overvaluation of those assets leading potentially to losses for the investors and financial stability issues. The number of sustainable investments is growing so that this question should solve itself over time, but the risk of overvaluation remains. ESMA noted in 2022 that

> "Concerns over 'green' asset overvaluation lingered, as the return on equity of less-polluting firms went into negative territory in 2020, while long-dated green bonds traded at a premium relative to other bonds."[42]

Ultimately, the issue of their profitability for investors is key.

E. Conclusion

The EU legislator has developed an ambitious agenda on sustainable finance and developed it at a very rapid pace. However, the consequences of both the speed and the nature of this agenda might not always have been analysed in sufficient detail.

As to the speed of the change, the SFDR has essentially tried to create demand from investors although the issue of the supply of investment products should have been fixed beforehand. This has created a significant gap between supply and demand. This gap will not be bridged until the CSRD is implemented in the Member States, which will be at the earliest in 2025 for the largest companies for their financial years starting on or after 1 January 2024. In the meantime, the risk of assets being overvalued due to scarcity remains high. As to the nature of the agenda, the risk of labelling certain activities as not being green although they contribute to decarbonisation, such as nuclear energy, or contribute to an orderly transition from fossil fuel, such as gas, remains high. Any mistake in the analysis could lead to underinvestment and high energy costs for both industry and consumers. Sustainable finance has to be implemented considering all aspects including its economic and social consequences as well as sovereignty issues. This is already what is happening in the US where, due to geopolitical developments, some investors think that it is necessary to adopt a more holistic approach to ESG.[43]

Finally, the sustainable finance agenda is indicative of a change from a market-based economy towards a more dirigiste approach the EU institutions and Member States finance sustainable investments while also promoting them to the private sector. The involvement of the private sector is necessary to meet Paris Agreement goals since public funding alone will not suffice. This approach is

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[42] ESMA, TRVRisk, Monitor ESMA Report on Trends, Risks and Vulnerabilities No. 1, 2022, ESMA document number: 50-165-2058 Publication date: 15 February 2022.

[43] G. Tett, "ESG exposed in a world of changing priorities", *Financial Times*, 3 June 2022, at: https://www.ft.com/content/6356cc05-93a5-4f56-9d18-85218bc8bb0c (21 June 2024).

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different from the successful ordo-liberalism approach of post-War Germany. Whether or not this more dirigiste approach is going to be economically and socially successful remains unclear, but it is already the most significant and visible consequence of the sustainable finance agenda.

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