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Policy Brief

Beyond transparency: Getting serious about greening Europe's financial system

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The financial sector must divest from unsustainable business. This is imperative to achieve a climate-neutral economy and to safeguard financial stability. The European sustainable finance regulatory agenda of 2018 launched important initiatives that increase transparency on climate risks. Now it is time to move to the second stage and incorporate climate risks in the risk models and capital requirements of banks, pensions funds and insurance firms. This will reduce their exposure to potential losses from climate risks and at the same time render sustainable investment alternatives more attractive.

Europe wants to become the first climate-neutral continent by 2050. To achieve this ambitious goal, European Commission president Ursula von der Leyen has put forward her strategy: the European Green Deal. EU climate action is nothing new, but the novelty of the Green Deal is that climate considerations are mainstreamed into all EU policy areas. According to the Commission, the shift towards sustainable technologies and business models requires an additional €175-€290 billion in annual green investment over the next few decades. A substantial part of the new EU budget and recovery plan will be spent on fighting climate change. However, the financing of the green transition cannot rely on public money alone. Pursuing the objective of encouraging substantial private investment in a climate-neutral economy, Europe is driving a regulatory agenda promoting sustainable finance.

The idea behind the sustainable finance strategy is at first sight simple: financial markets decide on capital allocation within the economy. If the objective is to reach a climate-neutral economy, climate change must become a relevant factor in financial decisions. This will reduce the attractiveness of unsustainable projects and increase investment in sustainable undertakings. However, on closer examination, making financial actors invest sustainably may not be that simple. Introducing minimum standards for sustainable financial products has little to no impact on the environment if those standards are weak or unenforced. Disclosing the carbon footprint of financial products cannot change the behaviour of investors fixed solely on immediate financial returns. Measuring climate risk is difficult as long as data is scarce and regulations for predictable emission reductions and carbon pricing are absent.

Despite these difficulties, there is a strong case for sustainable finance. Financial stability is at risk if market actors continue to disregard climate risks, for instance

in their risk modelling. If climate risks materialise in destroyed property and devalued natural reserves, the resulting financial losses will be substantial. Regulatory action forcing the financial services sector to incorporate climate risks in the pricing of assets can mitigate stability risks. And by rendering unsustainable projects financially less attractive, this promotes the necessary divestment from carbon-intensive sectors and with that the green transition.

This policy brief provides a guide through the numerous sustainable finance policy measures. It critically assesses their potential for increasing sustainable investment – and concludes that the most effective weapon is compulsory pricing of climate risks.

What policy measures are part of the agenda?

Under its widest definition, sustainability has three dimensions, namely environmental, social and governance – ESG. Given the importance of reaching climate neutrality by the middle of this century, the focus of the EU regulatory agenda so far has been on environmental considerations and here in particular on fighting climate change. Social and governance aspects are more difficult to grasp and will follow only later. This explains why the notion of 'sustainable finance' and 'green finance' are often used interchangeably. By 'green finance' we mean investment in eco-friendly projects or the opposite of 'brown finance' providing funding for technologies that harm the environment.

The European Commission in 2018 published its first Action plan on Financing Sustainable Growth setting out an EU strategy for greening the financial system. It involves various European institutions and agencies which have subsequently developed their own roadmaps. The numerous policy measures in the action plan and in the multiple roadmaps share the same ultimate objective: greater investment in sustainable businesses and technologies. However, their ability to change investor behaviour varies quite remarkably. The effectiveness of any individual measure hinges on whether it 1) merely enhances transparency or 2) has a direct impact on the relative price of green and brown investments.

1 Actions enhancing transparency

A first set of actions aims at increasing information about the sustainability of firms or financial products. These actions usually tackle two problems: that investors cannot be sure that an investment labelled as green does indeed benefit environmental protection or that investors and companies are unaware of their exposure to climate risks which may result in financial losses.

1.1. Tackling greenwashing

First, there are measures that tackle greenwashing in the marketing of products by the financial industry. These measures provide markets and investors with clear criteria to assess whether an economic activity or a financial product is environmentally friendly or not. Public standards are meant to guide investors through the jungle of privately developed standards. Private standards are difficult to compare and tend to confuse investors. Public standards are more reliable and bring clarity. If investors can be confident that they can indeed achieve their aim of being ecologically friendly, they will be more willing to invest in green finance.

Many firms are criticised for greenwashing because their products do not match the promise of being sustainable. Since "green" carries a positive connotation and can be used as an argument to charge higher prices or fees, firms have a strong incentive to satisfy the growing demand for sustainable products and services. However, in the absence of common sustainability definitions, they are free to choose from a multitude of labels developed by the industry or even apply their own standards. The greenness of some products is therefore dubious or indistinguishable for the average retail investor. The association of EU fund managers claims that it manages as much as 45% of financial assets in a sustainable manner. Such figures come with a health warning: if the financial services industry itself defines what counts as a sustainable asset, even corporations that engage also in unsustainable business clear the sustainability bar.

With the aim of bringing clarity and establishing a reliable standard for sustainability, the EU adopted the green taxonomy. It classifies economic activities according to their positive contribution to environmental objectives and provides investors and issuers with a harmonised and science-based definition of sustainability. The green taxonomy does not prescribe investments in environmentally friendly activities alone. But it is a toolkit for assessing whether a financial product or business is environmentally sustainable. The Taxonomy Regulation will start applying in 2022. The Commission is planning to specify technical details through delegated acts throughout 2021.

Building on the green taxonomy, specific measures tackling greenwashing have recently been adopted by European co-legislators or are being drafted by the EU Commission:

- The European co-legislators adopted common standards for carbon benchmarks which entered into application on 30 April 2020. Benchmarks measure the performance of financial products. Investors consult benchmarks before deciding where to put their money. Carbon benchmarks allow them to compare the carbon footprint of different investment alternatives.
- The European Commission is reflecting on whether to introduce an Ecolabel for financial products. Such an Ecolabel would allow investors to rely upon a trusted and verified certificate of the positive environmental impact of their investment.
- The European Commission promised to propose an EU standard for green bonds in 2021. A company issuing a green bond commits to put the money collected from investors into environmentally friendly projects. The EU green bond standard could require companies to spend money from green bonds only for projects that comply with the green taxonomy.

The establishment of reliable definitions, standards and labels facilitates the choice for investors and fosters consumer trust in green finance, but it raises three caveats. First, public minimum requirements for green financial products are not per se environmentally more beneficial than private sector criteria. The general principles of the EU green taxonomy are more rigorous than most standards currently applied by the financial industry. However, the specification of taxonomy-compliant activities is still outstanding and interest-driven politicking by some EU member states threatens to water down the proposals put forward by the Commission. Second, establishing new standards will probably not be enough to police greenwashing throughout the EU. Enforcement of EU financial regulation lies mainly with national authorities. To ensure consistent application of new standards across all member states, the French and Dutch market authorities for example call for European oversight of ESG ratings firms. Third, sustainability standards primarily guide the decisions of investors that wish to make a positive contribution to the environment. They may well not suffice to convince investors who care not a jot about sustainability to invest green. The sustainable finance toolkit therefore includes a second set of measures designed to make all financial market participants care about climate change.

1.2 Raising awareness of climate risks

A second bunch of measures aims at raising awareness of climate risks among investors and companies. These measures require banks, investment firms, insurance companies and other large corporations to assess the climate risks attached to their business and products and to make this assessment publicly available. This additional information is meant to influence business decisions within these companies, enhance transparency for investors and inform legislators, regulators and financial supervisors on the possible need for additional policy action. Policy measures that tackle greenwashing primarily benefit retail investors who want to invest green. By contrast, measures that illuminate climate risks address all financial market participants as in principle any investment may be affected by climate change.

Climate change and environmental degradation pose financial risks. First, physical climate risks such as floods and storms may destroy property and interrupt trade. They may have also indirect effects by increasing the costs for insurance companies that must pay out for the damage caused by weather-related natural disasters. Second, climate transition risks such as the introduction of a carbon tax may prompt a devaluation of assets dependent on fossil fuels. The adjustment process towards a climate-neutral economy threatens carbon-intensive business models and renders natural reserves like oil, gas and coal "stranded". So, climate change may well lead to financial losses with significant impact on the financial services sector itself.

Nevertheless, banks, pension funds and insurance companies have not yet adequately built climate risks into their risk calculations and business models. The reasons are manifold: risk calculations try to predict the future by building on previous events. Since losses from climate change are still to occur, they tend not to figure in most of current calculations. Furthermore, climate risks are difficult to measure as they lie in the distant future and their materialisation is highly uncertain with regard to time and scale. While the target of reaching climate neutrality by 2050 is well-known, policymakers have failed to deliver regulations for predictable emission reductions and carbon pricing that the financial services industry could feed into their calculations. Mark Carney, former governor of the Bank of England, described this dilemma as the tragedy of the horizon: climate change happens beyond the usual business and credit cycle.

Measuring climate risks is complicated by a lack of usable methodologies and comprehensive data. Large corporations including banks are required by law to disclose non-financial information. However, reliable, comparable, and easy understandable information on climate risks is still unavailable. This is problematic because data is the linchpin of the entire sustainable finance regulatory agenda. But for the time being, there is no central data repository that could pool relevant data and make it easily accessible. More and more rating agencies are trying to fill the information gap by offering specific sustainability ratings of companies. But their results substantially diverge one from the other owing to different scope and methodology in their rating approach. Consequently, investors and financial firms are often unaware of or unsure about the range of risks associated with their investment or business.

With the aim of making companies and investors pay attention to climate risks, banks, investment firms, insurance companies and other large corporations will be asked to assess their sustainability risks and disclose them to the public. European regulators have been tasked with developing more accurate and harmonised methodologies to help firms measure and report their sustainability risks. To stop retail investors from ignoring sustainability risks, financial advisors could even be required to actively advise on the sustainability of the financial products they offer. The most important work streams to make sustainability risks transparent for companies and their investors are the following:

- The European Banking Authority has been tasked by the European co-legislators with developing the specific sustainability information requirements that large banks and investment firms will need to fulfil as of June 2022 and December 2022, respectively.
- Insurance firms and large listed companies could face enhanced sustainability disclosure obligations similar to banks and investment firms. The European Commission said it would table a legislative proposal for the revision of the non-financial reporting directive in 2021.
- The European co-legislators agreed to oblige manufacturers of financial products and financial advisers to disclose to end investors how they integrate sustainability risks into investment decisions and the likely impact of sustainability risks on investment returns as of March 2021.
- The European Commission is envisaging to require investment advisers and insurance distributors to provide clients with information on the sustainability of the financial instruments they recommend. The European Commission published the corresponding draft delegated act but has not adopted the final provision yet.
- The European Central Bank expects banks to carry out a self-assessment on their environmental risks in 2021 and will focus its supervisory stress test in 2022 also on climate-related risks.
- The European Securities and Markets Authority expanded its voluntary guidelines on disclosure requirements for credit ratings by adding sustainability factors and the European Commission is currently assessing the need to follow up with binding legislative action.

Enhanced transparency on risks does not necessarily lead to a change in investment behaviour or business decisions. Requiring companies to assess and disclose their sustainability risks raises awareness within firms and among investors. However, it remains with each market participant to weigh chances against risks according to his/her individual risk profile and sustainability preferences. There is no guarantee that providing financial actors with all relevant information will make them decide rationally.

To sum up: Policy initiatives increasing transparency on the sustainability of firms or funds have only limited effects. Providing reliable information on the greenness of financial products brings clarity for investors. Raising awareness of climate risks may render financial decisions more sustainable. However, to make a real difference, the additional information on climate risks would need to be reflected in the pricing of investment alternatives. Incorporating climate risks in asset prices is the objective of the third category of sustainable finance measures.

2 Actions forcing financial firms to incorporate climate risks in asset prices

A third set of measures aims not merely at increasing transparency, but at forcing financial firms to incorporate information on climate risks in asset prices. Requiring banks, pensions funds and insurance companies to consider potential financial losses stemming from climate risks when buying shares and bonds or granting credit to companies will make them divest from high-carbon undertakings and invest in sustainable projects.

The fact that the financial sector is under-estimating climate risks is problematic for both financial stability and the green transition. First, as long as financial firms ignore their exposure to climate risks, they hold insufficient capital to weather potential losses from the repricing of stranded assets or the physical destruction of property. Since the environmental consequences and the devaluation of natural reserves will occur erratically, the unpreparedness of the financial sector severely threatens financial stability. Second, disregarding climate risks when granting loans or investing pension reserves and insurance premiums is distorting efficient capital allocation. As a result, loans to companies exposed to climate risks are cheaper than they would be if banks adequately reflected climate change in their risk calculations. And the demand of pension funds and insurance companies for shares and bonds of brown corporations is higher than it probably should be.

With the aim of safeguarding financial stability and increasing the attractiveness of green investments, prudential supervisors, regulators and legislators are exploring measures to force financial firms to incorporate climate risks in asset prices. There are two possible ways to make the financial services industry divest from stranded assets and invest in sustainable undertakings. One is to require banks, pension funds and insurance companies to hold more capital when granting credit to brown projects or when buying shares and bonds of high-carbon companies. The other is to allow financial firms to hold less capital for green loans, shares and bonds. Since capital has a cost, both measures change the relative price of green and brown assets. Another lever for increasing the relative attractiveness of green investment lies with the ECB that could give preference to sustainability-linked financial instruments in monetary policy operations including asset purchases. The most important initiatives that may force financial firms to incorporate climate risks in asset prices are the following:

- The European Banking Authority (EBA) has been tasked by the European co-legislators with reports on whether and how to include sustainability risks in the prudential supervision of banks and investment firms. These reports are due by June 2021 and December 2021, respectively. They will build the basis for potential legislative action asking banks and investment firms to hold additional capital for exposures to brown sectors.
- The EBA has been tasked by the European co-legislators with a report assessing whether holdings of green assets could justify a reduction of banks' regulatory capital requirements (the so-called green supporting factor). The report is due by June 2025 and will build the basis for potential legislative action allowing banks to hold less capital for exposures to certain green assets.
- The European Central Bank (ECB) accepts sustainability-linked bonds in its monetary policy operations as of January 2021 and is reviewing its overall strategy also with regard to the fight against climate change. To date, the ECB is not planning to give preference to green assets but if it decides to do so, this will render brown assets less attractive.

Work on the inclusion of climate risks in asset pricing is highly beneficial to the green transition and financial stability, but it has only just begun. The EBA will report on the need to include sustainability risks in banking supervision by mid-2021. However, before a binding requirement

for banks to hold additional capital for brown assets can enter into force, the European Commission has to make a legislative proposal and the EU co-legislators must approve this. Given the slow pace of the legislative machinery, it will take years before banks are required to back climate risks with additional capital. But it is not only the work on capital surcharges for climate risks that is still in its infancy. The EBA has until June 2025 to assess whether certain green assets carry lower risk that would justify a reduction in the capital requirement of banks. Some banking associations would prefer an immediate capital reduction to incentivise green lending. However, this demand must be treated with caution. Before green assets can benefit from a lower capital requirement, there must be clear evidence of the lower risk associated with sustainable projects and businesses. It is right to finally account for climate risks that had previously been ignored. But it would be wrong to begin disregarding credit default risk instead. For the sake of financial stability, there is urgency in backing climate risks with capital but incentives for green lending should not be rushed through.

For insurance companies and pension funds, work on capital surcharges for brown assets is even less developed than for banks. The European Commission announced an overhaul of the regulatory framework for insurance companies towards the end of 2021. But it needs to be seen whether the review of the Solvency II Directive will include measures to force insurance companies to hold more capital for unsustainable assets. In 2016, pensions funds were the first actors that the European co-legislators asked to assess sustainability risks. But the IORPs II Directive does not prescribe any capital add-ons for exposures with climate risk and the Commission has not said it will change this any time soon.

To sum up: Measures that require banks, pensions funds and insurance firms to hold capital according to their exposure to climate risks directly affect financial decisions. They provide strong incentives to divest from unsustainable business and render sustainable investment alternatives more attractive. Still, factoring in climate risks in the financing costs of assets is not sufficient to promote the green transition. By adopting regulations for predictable emission reductions and carbon pricing, policymakers have another strong lever to directly influence the price of investment alternatives. The sooner they make use of all such instruments, the better.

Conclusion

Sustainable finance matters. The financial services sector can play a crucial role in funding the green transition. And it must play this role if it is to preserve the basis of its existence. Transparency measures are welcome to tackle greenwashing and raise awareness on climate risks. They are a necessary but not sufficient condition for greening the financial system. A real change in the industry will only come about through price signals.

Measures forcing financial firms to incorporate climate risks in asset pricing have a direct impact on investment decisions. They change the relative financing costs of green and brown funding. These price corrections put an end to the artificially cheap financing of unsustainable projects. And they provide a strong incentive to reduce exposure to undertakings threatened by climate change.

The important work on specific capital requirements for brown and green assets is still in its infancy. Work on banks has just begun and so far, insurance firms and pension funds have been largely left off the regulatory agenda. This is problematic because the earlier the financial services industry begins to adapt, the better it is for financial stability and the fight against climate change.

It seems warranted for the European Commission to shift its focus now from transparency measures to forcing the financial services sector to incorporate climate risks in asset prices. Just as carbon pricing and carbon taxes increase the price of unsustainable activities in the real economy, capital surcharges for climate risks make the financing of brown undertakings more costly. The Commission's renewed sustainable finance strategy due in the course of 2021 would be the right moment to do so. Further ignoring climate risks poses the greatest threat: to our planet, and to the financial industry itself.

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