Global Counsel

Connecting the investor with the environmentalist: Europe's push for sustainable finance

Blog post by Practice Lead Carmen Bell, 18 December 2017

Speaking at the One Planet Summit in Paris last week, EU Vice-President Valdis Dombrovskis proposed a "major revamp of financial supervision" to accelerate Europe's transition to a low-carbon economy. The European Council supported these plans in Brussels last Thursday, including "pending legislative proposals" to "fully implement" Paris Agreement targets. While the details here seem vague, one key question is clear – how far must the EU go to address the persistent mismatch between investors' short-term horizon and the long-term nature of sustainable projects?

Dombrovskis' announcement could be positive for financial service providers – a growing market for innovative financial products, such as green bonds, boosted by the risk-weighted adjustment of capital requirements for sustainable investments, as has been done with SMEs and high-quality infrastructure. From the financial services perspective, these measures go hand in hand towards encouraging more long-term investments. This is combined with concerns that Europe is falling behind Asian markets in the development of green financing products to generate additional political momentum.

Some in Brussels are less convinced. Socialist and Green MEPs question a regime that narrows its focus to offering "rewards" for investing in green projects. Rather, they argue, a more comprehensive approach is needed. This means going beyond transforming investors' decision-making processes and entirely reshaping the scope of corporate responsibility.

The capital is there, DG FISMA's Olivier Guersent has stated, it's just not flowing to the right place. This suggests that, for all the emphasis on market-led initiatives, the Commission is also considering direct action to pressure financial actors into becoming more climate-friendly. This includes integrating environmental, social and governance factors into the mandate of the European Supervisory Authorities and redefining fiduciary duty to cover sustainability risks. The former would add a new, uncertain dimension to stress tests, while the latter would impact the value of short-term profitability.

The Commission is confident that this strategy, in conjunction with incentivising measures, would demonstrate the EU's commitment to the Paris Agreement while securing Europe's financial stability. As desirable as this sounds, many believe such a shift can only take place when we have a clearer picture of what "green" (or "brown") actually means in the financial sector, to avoid the risk of purely PR-led, corporate "greenwashing". The Commission's High-Level Expert Group on Sustainable Finance proposes a sustainable asset classification scheme, or taxonomy, to add clarity. However, achieving this remains challenging for two reasons.

First, there is the arduous process of getting the EU, especially Central European member states with large industrial legacies, to agree on definitions. Even for more advanced economies, there is the risk that an overly detailed scheme could disincentivise investment in innovative projects that do not qualify. This calls for some flexibility, and the Commission is looking at solutions outside the rigidity of EU legislation.

Yet, there are already arguments that this does little more than raise awareness. We have seen a version of this with the Financial Stability Board's Taskforce on Climate-Related Financial Disclosures, whose reporting guidelines were earlier hailed as a ground-breaking achievement but now seem to lack bite in the absence of hard regulation. Some critics, such as London-based research firm IHS Markit, also flag potential market distortion as companies rely upon divergent risk assessments, pricing methods and market assumptions to adhere to the guidelines, leading to a "false sense of security".

Second, the idea of green asset classification can worsen existing apprehension about the unlevel playing field mounting between East and West. More carbon-intensive economies, such as Poland, will point towards the rewards being offered to markets reliant on nuclear energy – such as France – as further evidence of a European agenda that marginalises their interests. This will undoubtedly generate difficult discussions once any Commission proposals head to Council level.

Financial incentives are one element of transforming to a low-carbon society and an important one. But as we await the High-Level Expert Group's final report in January, and the Commission's forthcoming Action Plan in March, focus will remain on bridging that gap between short-term, shareholder interests and the long-term needs of sustainable growth. While a new taxonomy is one way to bring financial actors to the table, expect to see some in Brussels push for a wider paradigm shift that goes beyond the sharing of best practices.