PAUL TANG

MEP, Committee on Economic and Monetary Affairs, European Parliament

The EUs sustainable finance agenda, a first step of many

The EU's sustainable finance strategy is a European success story and established the EU's leadership position in an aspect of financial regulation vital for the years to come. Its rationale is simple. The information investors needed in the 20th century no longer suffices in the 21st. Investors increasingly fear the impact of climate change on the value of their assets, and look to make their money work for people and planet. With a targeted set of rules, the EU allows investors to put these concerns front and centre.

To this end, the EU enacted two main pieces of legislation. The Sustainable Finance Disclosure Regulation creates a standardised format for adverse sustainability impacts of all investment products. The Taxonomy Regulation functions as a 'add-on' to the disclosure regulation with additional requirements for self-declared sustainable investments and an index of what economic activities can be considered environmentally sustainable.

Mandatory disclosures of negative sustainability impacts can have a significant impact. Banque de France found that financial market participants subject to 2016 rules on climate-related disclosures reduced their financing of fossil energy companies by some 40%. It shows that end-investors use non-financial information to reduce their exposure to climate risks and prevent potential lock-in investments. It also creates high expectations for the EU's disclosure regulation. But these expectations can only be reached if the technical standards implementing the disclosure regulation create a set of disclosures sufficiently wide to help investors target their investments.

The impact of the taxonomy regulation, at least in the short-term, is expected to be more subtle. The EU taxonomy sets a high standard for activities to be considered sustainable, and rightly so. Only activities that help us achieve a fully sustainable economy, with net zero greenhouse gas emissions, are classified as sustainable. This means that currently only a limited range of activities fulfil these requirements. It is currently expected that a mere 2.5% of EU funds have a taxonomy-aligned share of their portfolio of 5% or above. As investors may prefer taxonomy aligned activities, this may lead to a slightly lower cost of funding. However, as the chunk of our economy will not be covered by the taxonomy, investments in non-sustainable activities will continue unabated.

The EU's sustainable finance strategy should thus be developed further. To allow investors to divest from climate risks the wide range of activities that don't comply with the EU taxonomy should be ranked. Separating activities that are 'neutral' in their impact from activities that significantly harm our environment would be a step in the right direction.

In addition, the social and governance aspects of the sustainability agenda should not be forgotten. When protecting our planet, people's livelihoods should be protected too. A social taxonomy, indicating activities that contribute or harm certain social objectives such as human rights, equality or tax compliance, is therefore a logical next step. This will help investors with a social agenda, or those seeking to limit exposures to public outcries over, for example, working conditions, to better target their investments.

Lastly, for the financial sector to show accurately the impact of their investments they need access to the relevant information from investee companies. While companies are often willing to disclose non-financial information to investors, the quality of this data will undoubtedly improve with the update of the EU's non-financial reporting directive. Obliging large corporates to disclose the impact they have on people and planet as well as the risks a changing environment has on their business model, will be a logical next step in the EU's efforts to create a more sustainable economy.

While past EU action has already impacted financial markets, the first sustainable finance strategy was exactly that: a first. It started with the financial sector only, and with a primary focus on the fight against climate change. In its efforts to reach a fully sustainable economy, however, the EU will now have to look at the economy more broadly, bringing corporates as well as social sustainable issues within the scope of its sustainability framework.