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Where is sustainable finance in the CMU?

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Context

Europe aims to be at the forefront of international efforts to deliver on the UN 2030 Agenda and Sustainable Development Goals and the Paris Climate Agreement. In the context of the Capital Markets Union (CMU), the Commission has committed to unlocking the full potential of public and private investment to support the transition towards low-carbon, circular and resource-efficient economy, as indicated in the Action Plan published in early March 2018.

Meaningful disclosure

Short-termism in financial markets has been a topic of discussion in academic and policy circles alike, particularly in the wake of the financial crisis. The sustainable finance agenda could get the financial sector in sync with the needs in the real economy, namely those of households and non-financial firms. Nonetheless, the capital markets ecosystem is currently underdeveloped, and many underlying conditions are still missing. With respect to environmental, social, governance (ESG) factors, fully-fledged taxonomies, labels and ratings, reliable quantitative and qualitative non-financial corporate disclosures are expected to reduce information asymmetries and improve overall risk-return calculations.

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ESG integration

At present, there is a variety of approaches to ESG integration, preferred asset classes and investment strategies. At the institutional level, the EIB has a long-standing experience in this market reflected on both the assets and liabilities sides. Retail investors have been increasing their direct presence in recent years, but additional suitability evaluations should be conducted. Insurance companies, pension funds and asset managers have a fiduciary duty to act in the best interest of their end investors – asset owners, and therefore must be equipped to seize the opportunities and manage the risks arising from materially relevant ESG factors. A larger pool of sustainable assets is needed in order to bring about significant change. Moreover, ensuring that SMEs are not underrepresented in the investors' portfolio should remain a priority.

Financial regulation

Financial institutions will also have to re-assess their lending/investment portfolio against long-term material risks under various scenarios of transitioning to more sustainable economic models. For example, macro-prudential supervisors have recently flagged financial stability risk related to the carbon-intensive assets on the balance sheets of banks. The use of financial regulation as a tool to provide incentives or disincentives for investments deemed (un)sustainable should be exercised with great caution. Lowering banks' capital requirements or recalibrating the risk weights for insurers' requirements in line with a future EU taxonomy on sustainable activities must have a sound prudential basis, beyond the economic and political considerations of CMU. This is essential in order to avoid a build-up in asset bubbles and further misallocation of resources.

Conclusions

A huge learning curve appears to lie ahead. The financial sector cannot explicitly decide sectoral policies or offer substitutions for the steps that should be undertaken by the real sectors, i.e. transforming activities and operations and enabling business propositions that include ESG values across the whole market/supply chain. Nonetheless, financial actors can make sure that these changes are happening more swiftly and effectively. As regards corporates, there are multiple reporting standards and valuation models, often leading to misalignment with investor expectations. On the investors' side, there are challenges related to fiduciary duty expectations, the lack of investment vehicles and appropriate benchmarks. Transparency, proportionality, the right incentives, and ultimately financial performance will allow sustainable finance to go from niche to mainstream.

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