ECONOMY AND ECOLOGY 31.03.2022 | Agnieszka Smoleńska

The EU's green banking agenda isn't sustainable — yet

By 'greening' finance, the EU wants to put financial flows at the service of the transition to climate neutrality. But so far its efforts fall short

With each new IPCC report, scientific evidence of rapidly advancing climate change and its dire consequences for life on Earth is mounting. At the same time, Russia's invasion of Ukraine has led to a rude awakening as to the consequences of Europe's energy dependence on authoritarian regimes propped up by fossil fuels exports. In this context, accelerating Europe's socio-economic transition to climate neutrality is not just about preserving a habitable planet in the future, but a pragmatic policy choice in the short term.

This transition to a climate neutral future requires enormous financial resources. The European Commission estimates climate change mitigation and adaptation investment needs to be to the tune of €520bn a year. A large part of these resources is to be channelled through financial markets, which will need to be cleaned up and aligned with a 'net zero' future in the process. Greening banks is a core tenet of EU's climate neutrality strategy.

A policy harnessing investors' interest in sustainable projects is in line with current market trends. Sustainable finance – which takes environmental, social, and governance (ESG) criteria into account – has been on the rise. Annual issuance of various categories of sustainable bonds in the EU topped €110bn in 2021, while ESG assets under management in that year exceeded €11 trillion. What precisely lies behind ESG labels is, however, often opaque. The ESG segment is rife with green-washing, understood not only as false marketing but also as deploying contradictory definitions of sustainability.

The EU's Green Taxonomy

To tackle green-washing, the EU has recently introduced a Green Taxonomy. The regulation clarifies the technical criteria which business

activities have to meet to be considered as contributing to EU's six environmental objectives. In other words, the framework helps investors and companies identify when a given project contributes to climate change mitigation and adaptation, protecting air and water quality, biodiversity, waste management or advancing the circular economy. As an interface between environmental science and business activity, the Green Taxonomy lays the groundwork for more targeted regulatory action.

Will the EU's greening actions be enough to redirect financial flows so that the transition to climate neutrality meaningfully accelerates? So far, that seems unlikely.

Already the 2019 revision of the EU's bank microprudential rulebook introduced detailed climate and environmental (C&E) risk disclosure requirements for credit institutions, then followed by highly granular reporting templates developed by the European Banking Authority (EBA). With the 2021 Banking Package, the EU Commission took things further. Microprudential rulebook proposals would require bank management to pass a climate change-related 'fit and proper' test, while supervisors would be required to take action when they judge a given bank's strategy vis-à-vis climate change related risks is not up to scratch. Long-term plans as to how banks are planning to decarbonise – so-called 'transition plans' – would be required. Further regulatory advances are expected, such as bespoke treatment of C&E risk exposures in calculating capital which the banks are to hold.

Will the EU's greening actions be enough to redirect financial flows so that the transition to climate neutrality meaningfully accelerates? So far, that seems unlikely. The primary reason is that for now the EU regulatory framework is focusing largely only on what is 'green' with the aim of lowering the cost of capital for such activities.

EU regulations are not enough

While this approach is likely to spur welcome investment, there are at least three reasons why such it is incomplete if we have a 'net zero' future in mind. First, it does not acknowledge the wider redistribution of financial assets that will be needed for a green transition. Second, the focus on the banking sector creates arbitrage opportunities, which realised would undermine the very objectives of the EU's greening regulations. Finally, treating the three prongs of sustainability –

environmental, social, and governance – separately and interchangeably creates further risks for transition down the line; a more multifaceted and integrated approach is needed.

While incentivising innovation in green technologies is necessary, lowering banks' returns on green projects means they will compensate by taking more risky positions elsewhere. At the same time, financial actors will pressure governments into supporting sustainable investment with public guarantees and implicit subsidies of various types ('de-risking'). Likewise, diverting funds away from highly emitting (but important economically and socially) industries, will make their decarbonisation more expensive for the public budgets.

The EU's sustainable finance strategy will not work unless we recognise the multifaceted nature of the socio-economic transition to climate neutrality.

A narrow 'green' focus side-tracks the area where bulk of the action needs to happen: the transition efforts must catalyse change in the traditionally energy intensive industries and activities. A dedicated regulatory framework for such longer-term engagement is needed, e.g. through 'transition plans'. Where an industry 'upgrade' is not possible, stranded assets will materialise, with financial institutions having every incentive to off-load these to the public purse. We need transparent rules to capture how all these necessary losses and costs in the economy are distributed between the financial sector and the public budgets.

So far, the EU's regulatory efforts have focused largely on greening the banking sector. Somewhat slower has been the unfolding of regulations in other financial market segments, such as asset management, provision of ESG ratings, or regulation of specific 'green' financial products such as green bonds. Some acceleration is visible, with EU agencies responsible for money markets preparing dedicated 'sustainable finance' strategies in 2022. However, in the context of an ever-larger part of the lending activity taking place outside of the regulated banking sector, as long as a regulatory advancement across financial market segments is uneven, arbitrage opportunities abound – thus undermining the 'net zero' agenda.

Finally, the EU's sustainable finance strategy will not work unless we recognise the multifaceted nature of the socio-economic transition to climate neutrality. For now, despite the ESG risks being bundled together, the three aspects – environmental, social and governance – are largely treated separately and interchangeably. The Green Taxonomy for

example, deploys a 'do no harm' principle only to other environmental objectives. For a truly sustainable future such safeguards should apply also to the social and governance objectives. 'Greenness' of investments should not be disentangled from human and labour rights ('S') or rule of law and corporate governance standards ('G').

Towards a socially just 'net zero' future

An integrated approach is indispensable to ensure that the EU does not exchange dependence on one aggressive and undemocratic fossil fuel exporters for another. The importance of respecting human rights and the rule of law should not be an afterthought or separate objectives, but an integral part of any holistic ESG assessment. Such a framework will also make it easier to answer the contentious political questions with which EU is faced today: such as what type of new gas or nuclear projects should be considered sustainable.

The intertwining of environmental transition with other social and governance policy objectives requires further political guidance from policy-makers.

An integrated ESG approach would mean that any gas infrastructure investments run counter to long-term sustainability objectives when they lead to lock-in effects and increase dependence on imports from countries where social and governance standards are not respected. In the case of nuclear energy, conditioning ESG investment label on the commitment to stable, credible and accountable institutions can also help mitigate concerns about using this energy source. An integrated approach further reveals the emerging proposals to give defence investments an ESG label as a misuse of the framework.

The intertwining of environmental transition with other social and governance policy objectives requires further political guidance from policy-makers. Inevitably, widening the scope and complexity of the transition framework will come with higher compliance costs, which will require careful calibration and hand-on approaches by banking and other supervisors. More comprehensive action, integrated and cross-disciplinary thinking, as well as political leadership is however precisely what is necessary to achieve a sustainable 'net zero' future in today's fragmented and uncertain world.



Agnieszka Smoleńska
Warsaw

Agnieszka Smoleńska is an Assistant Professor at the Institute of Law Studies at the Polish Academy of Sciences and an Associate Researcher at the European Banking Institute.