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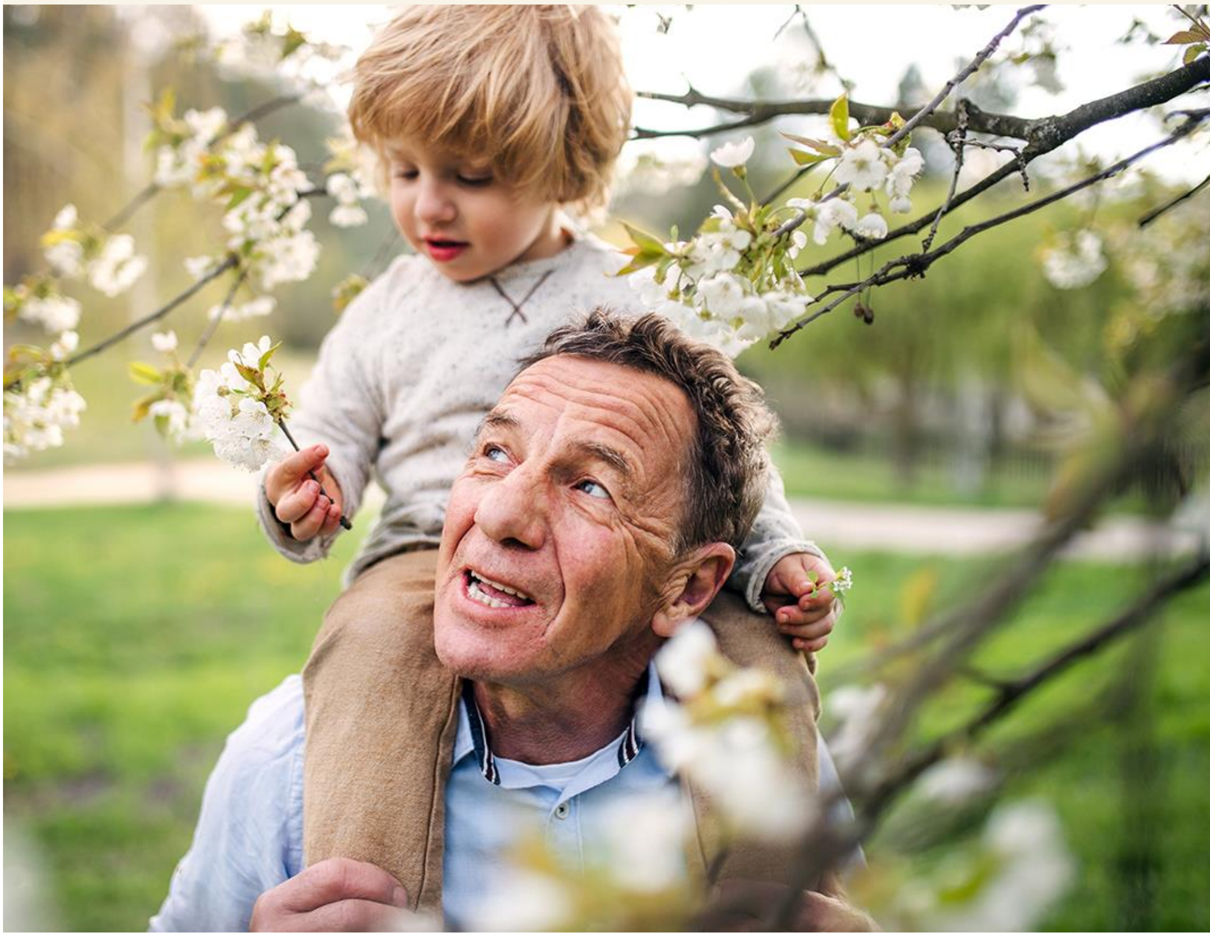
REPORT SEPTEMBER 2020

A VISION FOR SUSTAINABLE FINANCE IN EUROPE

FINANCING EUROPE'S FUTURE SUSTAINABILITY

SARA DETHIER AND KATE LEVICK



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About E3G

E3G is an independent climate change think tank accelerating the transition to a climate safe world. E3G builds cross-sectoral coalitions to achieve carefully defined outcomes, chosen for their capacity to leverage change. E3G works closely with like-minded partners in government, politics, business, civil society, science, the media, public interest foundations and elsewhere. In 2018 E3G was ranked the fifth most globally influential environmental think tank for the third year running.

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FOREWORD

By Octavian Bivol
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The COVID-19 pandemic has demonstrated the consequences of systematically underinvesting in resilience. The cascading nature of disaster risk, where one disaster can rapidly lead to another, coupled with insufficient investment in disaster risk reduction, makes the critical systems that trade, food, energy, transportation and health rely on increasingly vulnerable to hazards such as COVID-19.

This crisis is a wake-up call and an unprecedented opportunity to build back better with a renewed focus on resilience. We know that alongside the COVID-19 crisis, there is another crisis – the climate emergency. Climate change is occurring more quickly and intensely than previously thought possible. It poses a grave threat to financial stability and it has the potential to supersede the immense damage and loss caused by the COVID-19 pandemic. In the future, losses and disasters from climate impacts will increase dramatically if mitigation goals are not met and if we fail to ramp up resilience efforts. This recovery and transformation towards a climate resilient Europe are therefore interlinked, and must be pursued in a joined-up approach.

A crucial recommendation in E3G's report on a Vision for Sustainable Finance in Europe is the 'Think Resilience' principle. This test, to think resilience, means to make disaster risk reduction, climate change adaptation and resilience a baseline requirement for all European finance instruments. If incorporated into public finance investment decision-making across a range of instruments and actors, complementing the 'Do No Harm' oath, this could fundamentally re-orientate the financial system towards greater resilience.

As European Union member states emerge from the COVID-19 crisis, there is now a clear opportunity to build resilience into recovery activities. There is a wide range of actions that can drive this change. In 2020, the policy direction that will set through new institutional financial frameworks – including the

European Green Deal Investment Plan, the Recovery Plan for Europe, the Renewed Sustainable Finance Strategy, taxonomy and investment decision making – will set the pace of reforms to deliver a disaster-resilient future.

We have just 10 years left to deliver on what we all agreed in the Sendai Framework for Disaster Risk Reduction, the Sustainable Development Goals, and the Paris Agreement: to move towards a world more free of risk, where resilient, equitable and sustainable development can be made real; where no one is left behind. Finance stability sits at the heart of this. The EU’s next sustainable finance strategy will provide an essential contribution to truly building back better and ensuring a resilient future.

Octavian Bivol

EXECUTIVE SUMMARY

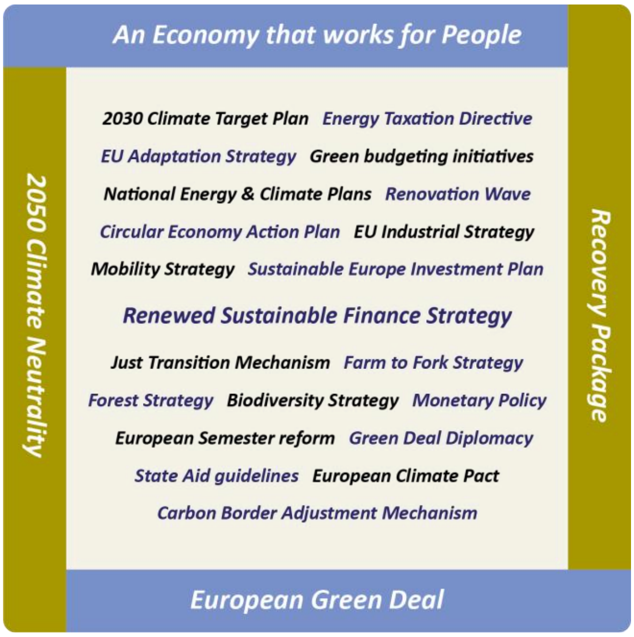
The financial policy choices made in Europe in 2020-21 will shape its prosperity for decades to come.

The road to recovery from the economic impacts of COVID-19 will not be quick or easy. But the current crisis is also an opportunity to direct large-scale investment towards creating a sustainable European economy.

Short-term economic relief measures must not mean financing longer-term risk and inequality. For ambitious financial reforms to be achievable and sustainable they must be fair and inclusive; their long-term success will be dependent on Europe's ability to guide international standards. Reforms must address public as well as private finance norms, including institutional architecture and governance.

This report aims to set out a vision for the future of sustainable finance in Europe and makes specific recommendations for action by European institutions within the next two years. It is published in the context of the upcoming Renewed Strategy for Sustainable Finance but is also relevant to other European policy frameworks.

Figure 1: EU policy agendas promoting sustainable economic recovery

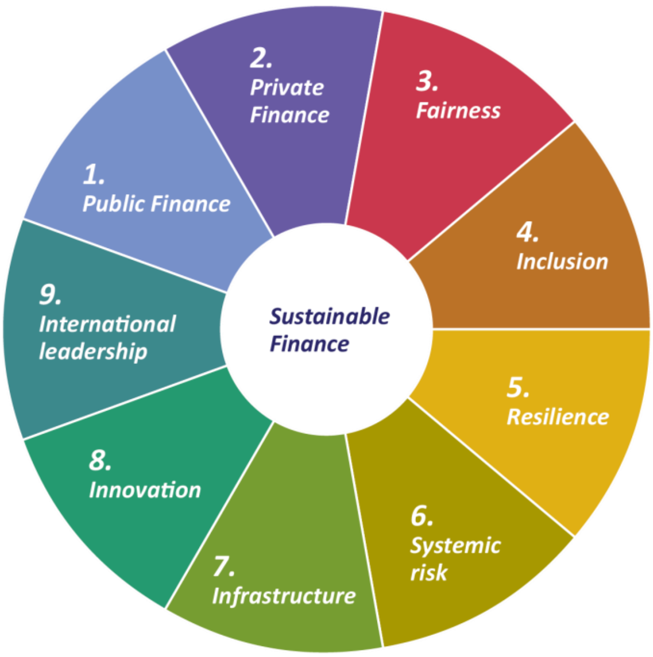


We hope that this paper will provide a helpful framework for a wide range of actors working on sustainable finance in Europe to think about the impacts of their work and the common goals that they are all trying to achieve, in the context of the European Green Deal and sustainable economic recovery from the pandemic. This includes the European Commission and other European institutions, but also civil society actors and philanthropic funders.

Given the breadth and multi-faceted nature of sustainable finance we have organised our research and recommendations under nine different themes which were identified through extensive consultation with subject experts: *Public Finance, Private Finance, Fairness, Inclusion, Resilience, Systemic Risk, Infrastructure, Innovation,* and *International Leadership*.

In selecting these themes, we have attempted to represent the variety and depth of different aspects of sustainable finance in Europe while also making connections and avoiding siloed thinking.

Figure 2: Policy themes for sustainable finance in Europe



Each chapter of the report contains several detailed suggestions. These have been summarised into three overarching recommendations for each theme, which are listed in the table on the following pages.

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Theme	Overarching recommendations
1 **Public Finance**	> Europe's wide array of public finance tools should be sustainability-proofed through use of the taxonomy and an exclusion list for significantly harmful investments, including the Multiannual Financial Framework, Next Generation EU and InvestEU. > The European institutions should apply sustainability-related and taxonomy-linked conditionality to state aid decisions and should support Member States to green national budgets and fiscal policy. > European institutions and Member States should adjust the mandates and capitalisation of public banks in order to achieve sustainability goals.
2 **Private Finance**	> European regulation of private finance should continue to set new standards for best practice, including a new requirement for financial firms to publish plans for their financed activities to be climate neutral by 2050 and to disclose progress against these plans annually. > The ongoing process to develop the taxonomy of sustainable economic activities must continue to be governed independently and based on science-based evidence. > Expectations of institutional investors should be strengthened beyond disclosure, to include integration of material ESG factors and long-term sustainability into investment decisions.
3 **Fairness**	> The European Commission should develop an Action Plan to promote fair access to affordable capital in Europe, including support for a more diverse ecosystem of financial actors. > The European Commission and European Investment Bank should build the capacity of stakeholders at regional and local level to develop bankable projects which support climate transition and social inclusion. > A broad approach to a transition that is both fast and just should be integrated into financial decision-making by a wide range of actors, starting at Member State level with the creation of plans to identify national financing needs and plans.

4 **Inclusion**	> The European Commission should ensure that retail investors are asked about their sustainability preferences and that sustainable investments are labelled for impact. > New policies should be put in place to ensure that European citizens' can exercise their right to sustainability-related data that is relevant to their lives and communities. > The European Commission should develop an Action Plan to address financial exclusion that is linked to sustainability issues.
5 **Resilience**	> A 'Think Resilience' principle should be incorporated into public finance investment decision-making to encourage risk assessment and resilience stress tests for investments, complementing the 'Do No Harm' oath. > The European Commission should propose a European public-private disaster risk finance pool to increase access to affordable and comprehensive insurance. > The European Commission should support Member States to adopt national and regional investment plans for climate adaptation and resilience.
6 **Systemic Risk**	> The European Commission should renew and link the mandates of the European Supervisory Agencies to enable a co-ordinated approach to climate-related financial risk. > The European Commission should create a taxonomy of unsustainable economic activities and the European Central Bank should conduct climate stress testing at European level. > The European Central Bank should green European monetary policy, and with the European Supervisory Authorities should ensure that banks and insurance firms are incentivised to manage climate risk, including through a risk-based differentiated capital requirement framework.

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7 Infrastructure

> The European Commission should support national capital raising plans for infrastructure by creating a European Panel on Climate Change responsible for advising Member States on infrastructure investments that are based on the least cost pathway to a net-zero economy.

> The European Commission and European Investment Bank should strategically engage with a network of public finance institutions to improve infrastructure project development capacity at regional and local level.

> Public finance institutions should support the creation of green infrastructure bonds in underserved regions and sectors.

8 Innovation

> The European Commission should build a cross-European approach to research and innovation and should design an innovation ecosystem that prioritises sustainability.

> The European Commission and Member States should expand the role of public finance institutions in crowding in private patient capital for investment.

> The European Commission should support Member States to align national approaches to research and innovation with European sustainability goals.

9 International leadership

> The European Commission should make finance a priority for Europe's international diplomacy in 2021 and should ensure that Europe takes a leadership role to drive international reform at the G7 and G20, and ahead of the COP26 climate talks.

> The European Commission and Member States should use the International Platform on Sustainable Finance to co-create new international financial norms, (for example, on taxonomy, disclosure, green bonds and financial sector transition plans) and should enrol more major economies as members of the Platform.

> The European Commission and Member States should make reform of public banks and development finance institutions in support of green recovery and systemic resilience a key pillar of their international finance diplomacy.

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INTRODUCTION

Financial choices and plans made at institutional level over the next 15 months will shape Europe's future. The Renewed Sustainable Finance Strategy will be a key opportunity for change.

The path to Europe's recovery will not be quick or easy. The short-term challenge is extremely daunting – Europe's economy shrank by 25-30% during the most intense period of lockdown and its gross domestic product is forecast to reduce by more than 8% in 2020, the largest output contraction since World War Two.[1] Member states are expected to emerge from recession with a wide range of recovery paths, and the shortfall in investment induced by the crisis is set to differ substantially between countries.

The current crisis is also an opportunity to direct large-scale investment towards creating a sustainable European economy. Choices and plans made at institutional level over the next 15 months will shape Europe's future. These policy choices will have long-term structural impacts and will have the potential to increase social cohesion, support biodiversity and climate action, and rebalance regional inequalities while building prosperity and resilience.

In 2020, long-term policy direction is being set through new institutional financial frameworks including the European Green Deal Investment Plan, the Recovery Plan for Europe, the Renewed Sustainable Finance Strategy, the European Investment Bank's Climate Bank Roadmap and the European Central Bank's Monetary Policy Strategy Review. Of these frameworks only the Renewed Sustainable Finance Strategy has a broad enough mandate to propose reforms to both public finance and private finance, making this a key Green Deal policy file.

Short-term economic relief measures must not mean financing longer-term risk and inequality. The IPCC's fifth assessment report of the same year showed that global greenhouse gas emissions must fall 45% by 2030 in order to keep the world below 1.5 degrees of warming. Action is urgently needed now, in relation to long-term investments in infrastructure which must be sustainable if Europe is to achieve climate neutrality by mid-century.

[1] European Commission (2020) **European Economic Forecast: Summer 2020 (Interim)**

For ambitious financial reforms to be achievable and sustainable they must be fair and inclusive. In order to manage trade-offs between short- and long-term economic support Europe will need to further develop its approach to financing a just climate transition. It will need to balance the transition risk and challenges faced by Central and Eastern Europe with the physical risks and impacts faced by Southern Europe, to ensure that no region is left behind during the economic transformation of the coming decades.

The shape of Europe's financial ecosystem is changing and must change further. Sustainable finance reforms designed in the context of private sector regulation are now being applied to European public funds under the Recovery Package. But to ensure that substantial investment reaches new industries and underserved regions it will also be necessary for existing institutions to act in new ways, and for new types of financial institution to emerge.

Successful implementation of financial reforms depends on Europe's ability to guide international standards. The financial system is global and European reforms in isolation cannot ensure sustainability. At the same time, Europe has a high level of global influence when setting new regulatory norms, for example the General Data Protection Regulation has been credited with inspiring 'a data privacy movement in both the corporate world and among international legislation'[2]. Europe can use this soft power to support its policy goals.

2021 will be a crucial year for employing European diplomatic firepower. With Italy leading the G20, the United Kingdom leading the G7, and both countries partnering to lead the COP26 UNFCCC climate talks, the European Union will have the opportunity to work with close partners to promote and internationalise its sustainable finance agenda. Europe has many tools at its disposal, from the International Platform on Sustainable Finance to the leading role played by Member States in international financial institutions and coalitions.

Now is the time to think long-term and create a new vision for financing Europe's future. The current crisis offers an opportunity to create a future for Europe's current and future citizens that is sustainable, resilient, inclusive and fair.

[2] Sovy (2019) **The Global Impact of the GDPR**