REPORT MARCH 2024

INVESTING IN EUROPE'S PROSPERITY

A VISION FOR FINANCING THE TRANSITION TO SUSTAINABILITY 2024–2030

E3G, SHAREACTION, WWF

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A VISION FOR FINANCING THE TRANSITION TO SUSTAINABILITY 2024–2030

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Authors' note

Meeting the investment needs to achieve the transition to a prosperous, safe, just and sustainable future in Europe requires complex solutions to mobilise both private and public finance, as interlinked elements within a single overall financial system.

This report explores these two elements and puts them in the context of a single paper with policy recommendations leading to 2030. We aim to give the reader a comprehensive picture of reform opportunities in relation to both streams of finance, and to highlight interactions between the two in the context of financing the EU's transition to a prosperous climate-neutral economy.

E3G, ShareAction and WWF Europe Policy Office have drawn on their respective areas of expertise to address the opportunities and challenges of the transition in this holistic way. The three organisations jointly developed the content and recommendations in the Introduction and Chapter 1 on private finance. Chapter 2 on public finance was led by E3G and reflects its views alone.

About E3G

E3G is an independent climate change think tank with a global outlook. We work on the frontier of the climate landscape, tackling the barriers and advancing the solutions to a safe climate. Our goal is to translate climate politics, economics and policies into action.

E3G builds broad-based coalitions to deliver a safe climate, working closely with like-minded partners in government, politics, civil society, science, the media, public interest foundations and elsewhere to leverage change.
www.e3g.org

About ShareAction

ShareAction is an NGO working globally to define the highest standards for responsible investment and drive change until these standards are adopted worldwide. We mobilise investors to take action to improve labour standards, tackle climate change, protect the natural world and address pressing global health issues. For nearly 20 years, ShareAction has used its powerful toolkit of research, corporate campaigns, policy advocacy and public mobilisation to drive responsibility into the heart of mainstream investment. Our vision is a world where the financial system serves our planet and its people.
www.shareaction.org

About WWF

WWF's mission is to stop the degradation of the planet's natural environment and to build a future in which humans live in harmony with nature. The European Policy Office contributes to this by advocating for strong EU environmental policies on sustainable development, nature conservation, climate and energy, marine protection, sustainable finance and external action.
www.wwf.eu

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The views represented in this paper are the authors' own.

Within E3G, the report benefitted from review and inputs from (in alphabetical order): Adrien Collache, David Nemecek, Domien Vangenechten, Franklin Steves, Kate Levick, Laura Sabogal Reyes, Lisa Fischer, Manon Dufour, Marc Weissgerber, Ronan Palmer, Sima Kammourieh, Steffen Menzel and Vilislava Ivanova. A special thanks to Daniele Gibney and Isabel Syrek for communications and copy-edit support.

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CONTENTS

EXECUTIVE SUMMARY

The transition to sustainability will enable social, economic and financial prosperity and stability in the European Union (EU). The EU's climate targets set out in the European Green Deal demonstrate its commitment to achieving a fair and prosperous future for all citizens. Achieving those goals requires mobilising significant private finance towards the sustainability objectives. Public finance also needs to work harder and smarter to shift the system and bring in more private finance. Policy choices will have to be made against a backdrop of challenging geopolitical, economic and social dynamics.

In the 2023 Strategic Foresight Report, the European Commission estimates the need for additional €620bn investments per year to meet the objectives of the European Green Deal and REPowerEU.[1] Those objectives include decarbonisation targets, but also creating a sustainable and competitive economy that protects the EU's natural capital, and the health and wellbeing of its citizens. The intensity of climate impacts is already showing us the costs of inaction – in both economic and human terms.

The funding needs are significant, but far from insurmountable. Much can be achieved by making sure more existing finance – both private and public – ends up in the right place. However, the conditions under which these decisions will have to be made in the coming five years have become challenging. Multiple crises, increased inflation and social inequality, and geostrategic competition have affected the political space and support for the sustainable transition in Europe. To achieve sustained political and popular support for the transition, its benefits must be confidently communicated, including inclusion, safety and economic competitiveness.

Our report makes recommendations for developing a smarter and better regulatory framework for sustainable finance in the EU, and explores opportunities for deploying public finance more effectively and at scale.

[1] European Commission, July 2023, **2023 Strategic Foresight Report** (PDF)

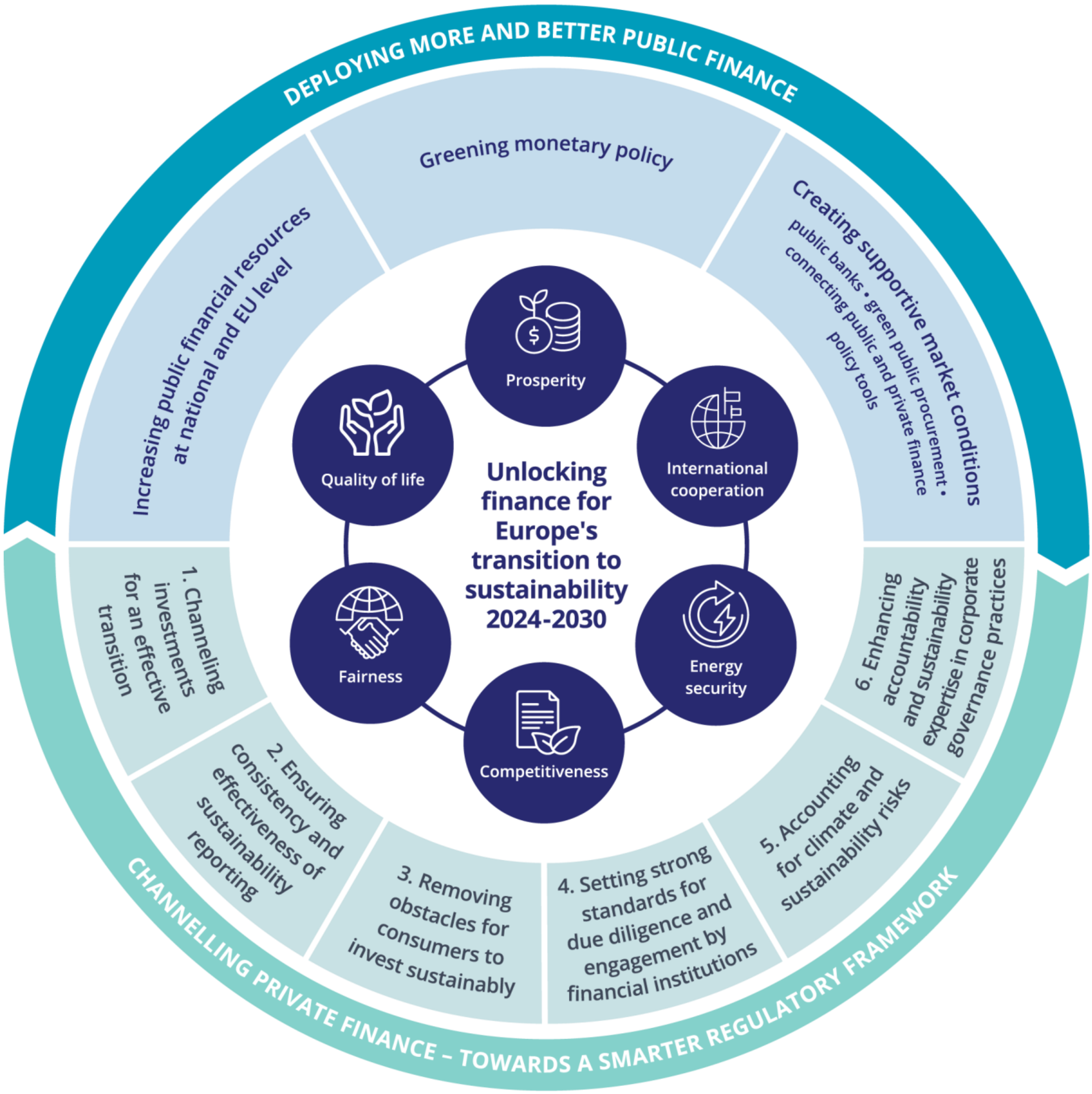

Figure 1: More finance – both public and private – needs to end up in the right place to secure Europe's transition to sustainability. A smarter regulatory approach to private finance needs to work in concert with more effectively deployed public finance.

Achieving a harmonised sustainable finance regulatory framework

Too much money is still paying for activity that runs counter to the goals of the transition. Estimates show that three-quarters of the funding gap for decarbonisation by 2050 can be filled simply by diverting existing finance from harmful or superfluous activities, into those that will deliver the transition.[2]

The EU has already shown excellent leadership in promoting ambitious sustainable finance legislation, and the existing regulatory framework is a good basis to work from to make it more coherent and workable. To date the EU's focus has been on encouraging transparency and making it easier for investors to identify sustainable activities to invest in. Now, action needs to move to providing stronger incentives for investors to put their money towards sustainability objectives.

The system needs to be coherent, easy to navigate, and speak to all potential users from consumers to financial institutions. We provide detailed recommendations in support of six key objectives for private financing.

1. Channelling investment for an effective transition

> Establish a single mandatory transition plan framework to streamline reporting, target-setting and implementation requirements for corporate transition plans. Currently these are too fragmented and unclear, creating legal ambiguities and administrative challenges for organisations.

> Expand the scope of the EU taxonomy to make it more comprehensive and robust. It should cover activities that are not environmentally sustainable but may be in the future, and those that will never be sustainable and should therefore be decommissioned. The taxonomy should also define socially sustainable activities.

> Further align the EU Green Bond Standard with the EU taxonomy and make the standard mandatory.

[2] Institut Rousseau, January 2024, **Road to Net Zero, Bridging the Green Investment Gap**

2. Ensuring consistency and effectiveness of sustainability reporting

> Prioritise the development and adoption of robust sector-specific corporate sustainability reporting standards and enhance requirements and reporting quality.

> Embed sustainability disclosure requirements in relevant legislation beyond the Corporate Sustainability Reporting Directive and European Sustainability Reporting Standards, to ensure consistency.

3. Removing obstacles for consumers to invest sustainably

> Create a mandatory product categorisation system that includes minimum criteria for sustainable investment products under the Sustainable Finance Disclosures Regulation.

> Strengthen sustainability provisions in the retail investment strategy.

> Better define and integrate sustainability into product and sectoral legislation such as the Mortgage Credit Directive, Distance Marketing of Consumer Financial Services Directive and Unfair Consumer Practices Directive.

4. Setting strong standards for due diligence and engagement by financial institutions

> Set mandatory due diligence requirements for financial activities.

> Set more comprehensive due diligence requirements for environmental matters.

> Ensure a higher standard for investor engagement.

5. Accounting for climate and sustainability risks

> Reflect the risks of activities that are not aligned with the EU climate objectives in the risk-based capital requirements.

> Ensure that credit ratings adequately integrate sustainability risks.

6. Enhancing accountability and sustainability expertise in corporate governance

> Ensure that companies' remuneration structures do not incentivise directors to favour short-term financial gains.

> Better regulate corporate lobbying, which weighs EU policy decision-making towards short-term industry interests.

> Engage stakeholders in a debate on corporate purpose to maximise shareholder value.

Putting public finance to work in support of the transition

Public investment is crucial to achieving the transition. There are many situations – such as public transport, and home retrofits for people on low incomes – where public funding is the only viable solution. Moreover, investments in resilient public services, and providing financial support for regulatory initiatives, are essential to maintain social cohesion.

Raising public funding at national and EU level

There are significant opportunities to free up public funds at the national level:

1. Phase out environmentally harmful subsidies.
2. Reduce public budgets' exposure to fossil fuel price volatility and anticipate costs for climate risks and damages in multi-year budgetary planning.
3. Apply progressive taxation on carbon-intensive consumption.
4. Use corporate tax policy to encourage sustainability, aligned with the EU taxonomy.
5. Include the cost of inaction in debates about investments.

EU-level funding is also crucial, to protect the single market in the face of mounting international competition, and to invest in European public goods as well as private sector sustainable projects. The pressures of EU enlargement and debt repayment also mean there will be more strain on EU budgets. There are two principal ways to leverage additional EU public funding:

1. Issuance of common debt, the effectiveness of which has been demonstrated by the Recovery and Resilience Facility.
2. EU levies and tax transfers, following the pioneer examples of the plastics tax and the Carbon Border Adjustment Mechanism.

Greening the European Central Bank's monetary policy

Monetary institutions need to find a way to address the high interest rates and increased capital costs that are likely to arise in the shift towards the transition to sustainability. The current ECB approach of tightening monetary policy restricts the fiscal space for investment.

In a high-interest rate environment, central banks should consider tools to incentivise borrowing and investment in green projects, for example dual interest rates.

In its review of its collateral framework, the ECB should recognise that environmentally harmful assets are at high risk of losing some or all of their value in the transition. It should integrate this risk into the framework by excluding such assets, or applying haircuts according to the level of environmental impact of the asset.

Smarter deployment: leveraging the system towards the future

It is not enough to have public funding available for investments into the transition – it is necessary to effectively deploy it to crowd in private finance, create market demand for activities and solutions that support the transition and provide strong signals to financial market players. There are three areas where the EU's public institutions, policy levers and tools can be strengthened to better deploy public funding for the transition:

1. **Public banks**. European public banks should be utilised more for their knowledge to spur the transition at EU, national and sectoral level. They should take on more ambition and go beyond just aligning with existing EU legislation to address the EU's deep decarbonisation challenge. In addition, the mandate of public banks should be revised to attract a more diverse team of personnel, able to provide tailored and cutting-edge technical assistance. This will support both the project ideation and the financial modelling needed to finance transition-related solutions. Enhancing and mainstreaming the use of innovative financial instruments, and financing resilience and adaptation across Europe, should also be core functions of EU public banks.
2. **EU green public procurement.** This should be an appealing prospect as it entails changing the conditions for existing public finance, rather than increasing the amount of finance. Public procurement could be an especially powerful tool for driving the transition in heavy industries such as steel and

cement, where public investment can help de-risk investment in low-carbon production methods.

3. **Linking public finance more explicitly to the EU sustainable finance framework.** National and EU-level financing could additionally both leverage private investments and support companies in their transition by aligning those mechanisms with the current sustainable finance policies and tools for the private sector. Notably the taxonomy's 'do no significant harm' principle and criteria, and transition plan supervision under the due diligence directive (CSDDD) would be powerful incentives if mainstreamed into public spending.

INTRODUCTION

FINANCING THE TRANSITION, IMPACTING THE FUTURE

In 2019, the European Union (EU) pledged to make Europe the first climate-neutral continent by 2050 under the European Green Deal (EGD), committing to achieving a sustainable, fair and prosperous future for all Europeans.[3] The EGD represents a new social pact, offering a pan-European vision with economic, technological, social, international and political dimensions. It aims to create a sustainable and competitive economy that can protect the EU's natural capital, and the health and wellbeing of its citizens. With the 2021 European Climate Law, the EGD's climate target became law.[4]

To achieve this economic transformation, large amounts of investment must be mobilised across diverse industrial sectors and European regions, from both private and public sources. The European Central Bank (ECB) estimates that an average of €1.25 trillion per year will be required for the period 2021–30[5], and €1.5 trillion[6] a year from 2031 to 2050, to achieve economy-wide climate neutrality.

The scale and pace of the financial flows needed for this transition requires Europe to rethink what it means to be competitive, and to transform its financial system and its companies' business models.

[3] European Commission, December 2019, **The European Green Deal (PDF)**

[4] European Commission, **European Climate Law - European Commission (europa.eu)**

[5] European Central Bank, June 2023 (revised), **The climate change challenge and fiscal instruments and policies in the EU (PDF)**

[6] Financial Times, 23 January 2024, **EU must invest about €1.5tn a year to meet net zero targets, says Brussels**

There have been significant achievements in the past five years…

The EU is a first-mover in encouraging sustainable investment

The EU has made strides in setting out the foundations for the necessary economic transformation. This has included developing and adopting regulations and market tools to secure a flow of high-quality private finance into the transition to a sustainable economy. Several key policy frameworks and regulatory packages have been issued in recent years to redirect the flow of finance in support of the EU's sustainability, and to ensure responsible investor behaviour.

In 2021, the European Commission launched the sustainable finance strategy,[7] building on the 2018 sustainable finance action plan.[8] The strategy aims to improve the transparency and credibility of sustainable finance in the EU, enhance the access to finance for businesses and individuals, and increase the resilience of the financial sector. Under these policy frameworks we have seen the adoption of the first detailed list of sustainable economic activities (the EU taxonomy), a step change in the availability of sustainability information for investors, and the development of market tools to enable the creation of sustainable investment products.

At the same time, the EU has used its first-mover position to inspire and help other countries to take similar steps. The EU taxonomy, for example, has inspired over 40 other jurisdictions to develop their own versions, while progressive EU corporate sustainability disclosure requirements have influenced the development of new international sustainability reporting standards by the International Sustainability Standards Board (ISSB).

Unprecedented public investments in the green transition through the EU budget and new funding

In its 2021–2027 Multiannual Financial Framework (MFF), the EU's long-term budget, the EU committed 30% of its budget to climate and environmental action – up from 20% in the previous period – aiming to respond to immediate investment needs and tackle the social and distributional dimensions of the transition to sustainability.

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[7] European Commission, March 2018 (updated August 2020), **Renewed sustainable finance strategy and implementation of the action plan on financing sustainable growth**

[8] European Commission, March 2018, **Action plan: Financing sustainable growth**

Several financing tools were set up to channel this and additional money into supporting the EGD and transitioning the economy to climate neutrality and environmental sustainability. They included the massive and unprecedented Recovery and Resilience Facility (RRF) set up for the period 2021–26, the Just Transition Mechanism (JTM), and InvestEU. Member states have been required to allocate at least 37% of the funds they receive under the RRF to supporting climate action and other environmental objectives.

The European Investment Bank (EIB) and other financial institutions have planned to disburse a further €192 billion into climate action and environmental sustainability for the 2021–2027 period in the form of loans and equity investments.[9] Through a leveraging effect, the total public and private investments mobilised through this initial financing by EIB and InvestEU is expected to reach €522 billion over 2021–2027.

… yet the finance gap for Europe's transition remains considerable

Only halfway to the Green Deal target

Despite this progress, more finance must flow into the transition, and faster, to achieve a safe future for Europeans. According to recent estimates the total amount of investment necessary to decarbonise the EU economy by 2050 is approximately €40 trillion, 10% of the current EU GDP.[10] Three-quarters of that estimate can be secured by diverting and reallocating current superfluous or harmful expenditures to deliver the transition. The remaining amount must come from additional public and private funds.

There is evidence that current investment levels must double[11] to reach the 2030 targets set out in the EGD, and a third[12] of the funds would have to be public money. The estimated annual investment needed over 2021–30 is approximately €1.25 trillion.[13] Yet, EU direct budgetary financial support for the 2021–2027

[9] European Court of Auditors, 2021, **Sustainable finance: More consistent EU action needed to redirect finance towards sustainable investment (PDF)**

[10] Institut Rousseau, January 2024, **Road to Net Zero, Bridging the Green Investment Gap**

[11] European Commission, July 2023, **2023 Strategic Foresight Report** (PDF)

[12] Politico, February 2024, **EU must find "enormous amount" of money to face global challenges, Draghi says**

[13] European Court of Auditors, 2021, **Sustainable finance: More consistent EU action needed to redirect finance towards sustainable investment (PDF)**

period is set at only over €87 billion[14] per year, around 7%[15] of that total. Taking other sources of finance into account, additional over €600bn[16] more per year must still be mobilised compared to annual investment in climate and energy security during the past decade (Figure 2).[17]

Addressing the investment deficit requires a comprehensive approach that involves existing and future regulations, carbon pricing schemes, and public finance to stimulate private investments.[18]

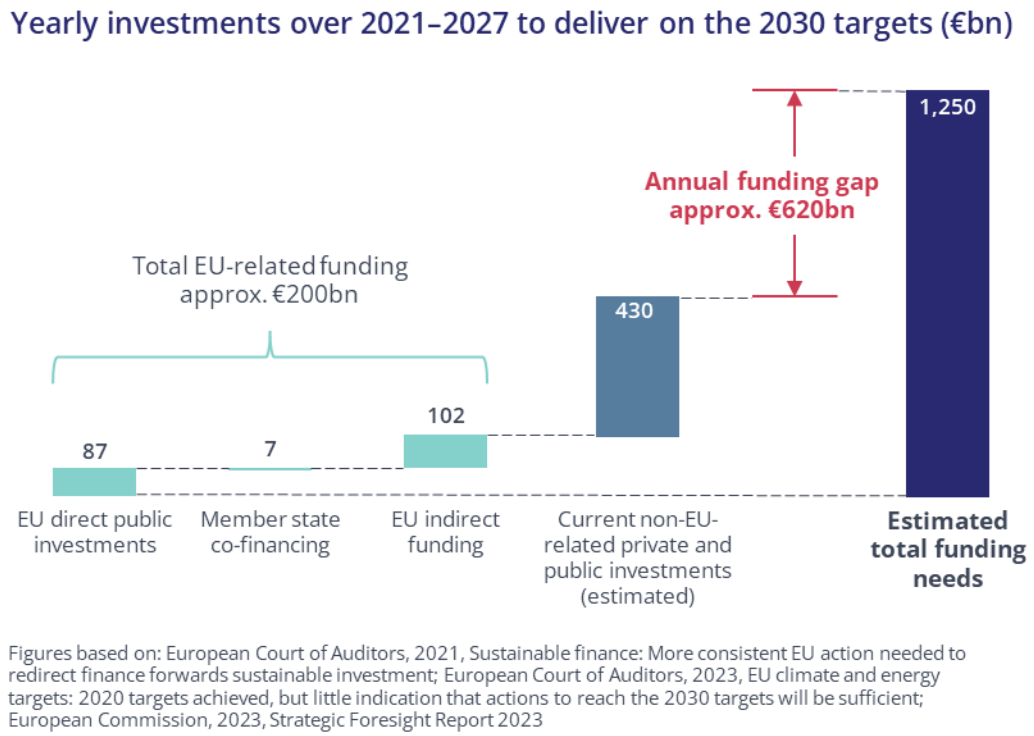

Figure 2: More than €600bn additional funding – a doubling of current projections – is needed every year to achieve the 2030 targets set out in the European Green Deal.

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[14] A total of €610 billion over 2021–2027.

[15] European Court of Auditors, 2021, **Sustainable finance: More consistent EU action needed to redirect finance towards sustainable investment (PDF)**; and European Court of Auditors, June 2023, **Special Report 18/2023, EU climate and energy 2020 targets achieved, but little indication that actions to reach the 2030 targets will be sufficient**

[16] To meet the objectives of the Green Deal and RepowerEU according to the State of the Energy Union Report 2023, in addition, the Net-Zero Industry Act requires in total €92 billion over the period 2023-2030; European Commission, October 2023, **State of the energy union report 2023** (PDF)

[17] European Central Bank, November 2023, **Making finance fit for Paris: achieving "negative splits", Keynote speech by Frank Elderson, Member of the Executive Board of the ECB and Vice-Chair of the Supervisory Board of the ECB, at the conference on "The decade of sustainable finance: half-time evaluation" organised by S&D and QED**

[18] I4CE, February 2024, **European Climate Investment Deficit report - An investment pathway for Europe's future** (PDF)

The challenge of increasing both public and private finance

Recent projections show a progressive decline in public funding capacities of the EU's largest financial instruments allocated to the environmental[19] and social transition – a mix of direct and indirect financing. The RRF is a particular case: set to provide a total of €723.8 billion over six years to implement reforms and investments to deliver the digital and green[20] transition, will end in December 2026, creating a significant funding gap.

The EU must now work out how to increase public spending capacity in a challenging global geopolitical and economic climate, with EU monetary and fiscal policy standing out as key areas that will require agreement. Fiscal rules are crucial for enabling the public investments that will be key to achieving the EU's climate and environmental goals, integrating risk and resilience mechanisms, and building ecosystem and biodiversity protection and preservation.

In addition, much faster progress is required in mobilising the necessary private finance. The average share of sustainable finance penetration over 2017–2021 is only about 9% of aggregated capital markets activity in the EU.[21] Penetration has been highest in the corporate bond market, slightly lower in loans, and much lower in equity markets.

Considering the EU's actual needs there is still a substantial gap. To keep the economy on track to reach climate neutrality targets, the volume of sustainable, transition-oriented finance raised on the EU capital markets needs to maintain the recent high growth rate (Figure 3) and double or triple in the next few years,[22] as also estimated by the Intergovernmental Panel on Climate Change (IPCC).[23]

[19] Bruegel, September 2023, **A new governance framework to safeguard the European Green Deal**

[20] Ibid.

[21] New Financial, June 2022, **A reality check on green finance: Analysis of the size, growth & penetration of green finance in European capital markets (PDF).**

[22] Ibid.

[23] IPCC, 2022, **Investment and finance** (PDF). In IPCC, 2022: Climate Change 2022: Mitigation of Climate Change. Contribution of Working Group III to the Sixth Assessment Report of the Intergovernmental Panel on Climate Change

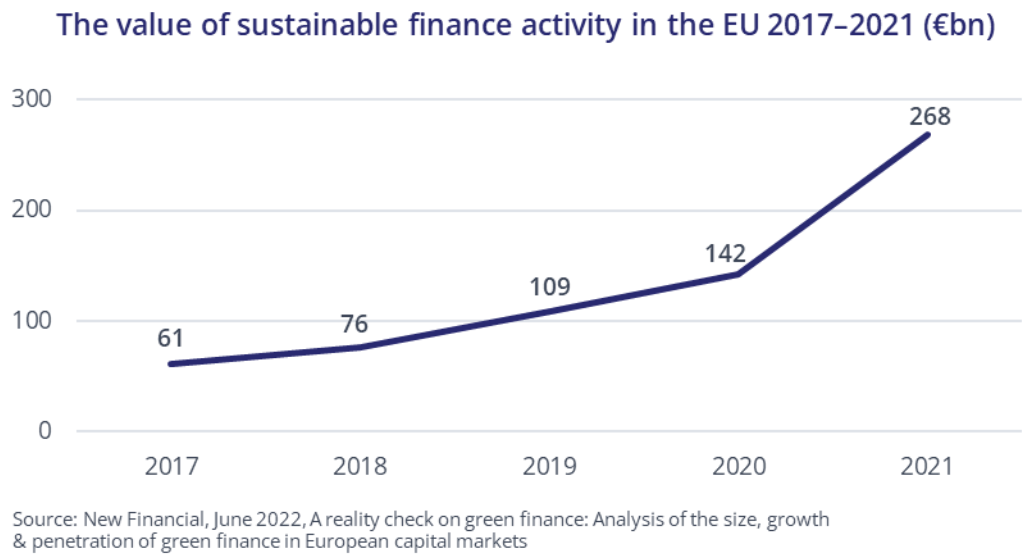

Figure 3: While corporate and financial entities are making pledges to transition to net zero, the amount of private capital needed to meet these promises is falling some way short.

The EU's climate transition requires not just more finance, but *better* finance

Additional policy and regulatory levers are needed to scale up financial flows into clean, sustainable activities, to progressively reduce subsidies for high-emitting activities, and to facilitate the absorption of already allocated funding at member state level. The lack of absorption capacity has significantly hampered the optimal allocation of previous funding programmes.[24,25]

In addition, much can and should be done through normative action at the EU level to signal to the private sector that investment in sustainability means investment in economic prosperity. For example, public finance policies and investments should strongly signal the overall economic direction of travel. Investment in innovative technologies should be consistently supported in partnership with the private sector, especially small and medium-sized enterprises (SMEs) and companies which require capital injections to transition (such as in the energy and infrastructure sectors).

Using public finance to crowd in private sector finance, and to provide subsidies to research and development programmes, will be key to unlocking the

[24] European Commission, July 2022, **Review report on the implementation of the Recovery and Resilience Facility** (PDF)

[25] Financial Times, 20 February 2024, **Is the EU's Covid recovery fund failing?**

innovative potential of the transition and to supporting the transformation of the current socio-economic, industrial model it will inevitably impact and challenge.

In the next five years EU policymakers will therefore have to make critical decisions for financing Europe's future and achieving its climate and sustainability goals. The political and policy choices made over the next five years will determine whether European citizens will benefit from safety and prosperity in the years to come, and whether the EU will continue to be an international leader in the fields of climate action and sustainable finance. Yet the conditions under which these decisions will be made are become increasingly challenging.

New challenges are shaping the political and socio-economic space for financing the transition

The decisions that European policymakers will need to make, if they are to mobilise financial flows at the scale and pace necessary for the transition, will require EU leaders to actively engage and reaffirm their commitment to the transition. They must do so against a backdrop of growing political and geopolitical complexities that are putting pressure on popular and political support for the European Green Deal.

Europe's political and geopolitical context has shifted considerably in the past five years, driven by multiple crises including the COVID-19 pandemic, the Russian war in Ukraine, and the conflict in Gaza in the Middle East. High inflation has increased social inequality, disproportionately affecting poorer citizens and contributing to a rise in populist politics. The US Inflation Reduction Act and China's industrial policies have put pressure on Europe to preserve its economic competitiveness.

This complex mix of factors, complemented by a sharp surge in the cost of living across the EU,[26] has led to growing anxiety about the sustainable transition.[27] For example, climate policy has been increasingly criticised for ignoring the lived reality of ordinary citizens and of the economy. Such anxiety and growing distrust have put pressure on the EU's political commitment to achieving the

[26] European Parliament, June 2023, **EP spring 2023 survey: Democracy in action – one year before the European elections**

[27] European Commission, fieldwork May–June 2022, **Special Eurobarometer 527: Fairness perceptions of the green transition** (PDF). 88% of EU citizens support the green transition, yet only 46% are confident that by 2050 sustainable energy, products and services will be affordable for everyone, including poorer people.

sustainable transition, contributing to a backlash against the European Green Deal among several parties in the European Parliament, mirrored by similar dynamics within some member states.[28]

To win sustained political and popular support for the transition, political leaders must confidently communicate its benefits. This will need to include communication of the redistribution, fairness and inclusion aspects of the transition, in order to ensure the support of *all* stakeholders, including those who are disadvantaged in today's economy.

The benefits of the climate transition are significant

Fairness and inclusion must be at the heart of a successful European climate transition. The effects of climate change can have a direct impact on inflation dynamics, which intensifies inequalities due to the resulting inflationary pressures on food or energy prices coupled with a decrease in purchasing power. A lack of climate mitigation and adaptation will result in deeper energy poverty, social exclusion, and territorial asymmetries across the EU, with the most vulnerable citizens among those most impacted by increasingly damaging physical climate impacts and disasters. Younger citizens are acutely aware of this issue: nine out of ten agree that tackling climate change would improve their health and wellbeing.[29]

Leaning into the climate transition is also good for the competitiveness of the EU industry. According to the 2022 Competitive Sustainability Index[30], EU countries that have identified and pursued a sustainability agenda for a longer period are those that have been able to improve competitiveness overall, including economically. Innovative and sustainability-oriented projects are increasing in key economic sectors within the EU and represent the main factors contributing to its global competitiveness. In other words, the transition mobilises large-scale resources and makes major transfers, particularly in terms of investments that are transformative of the European economy. The transition is now being

[28] Le Monde, 29 January 2024, **Europe's Green Deal is attacked on all sides**

[29] European Commission, July 2023, **2023 Strategic Foresight Report** (PDF)

[30] University of Cambridge Institute for Sustainability Leadership (CISL), December 2022, **Competitive Sustainability Index: New metrics for EU competitiveness for an economy in transition**

considered “macro-critical”[31,32] – crucial for the betterment of socio-economic conditions for all. Indeed, the Communication from the European Commission on the EU 2040 Climate target frames climate policy as an *investment policy*.[33]

Inaction will bring significant economic costs

Intensifying climate-related impacts have already taken a toll on various sectors of EU member states. Greece, for example, experienced wildfires and floods in 2023 that cost billions of euros and a quarter of its agricultural output, in addition to loss of lives, jobs and livelihoods in the agriculture and tourism sectors. Similar adversities have affected Italy, Spain, France, Germany, and other EU countries. According to the European Environment Agency, since 1980 climate-related weather events have caused 220,000 deaths in the EU and cost the bloc €650bn.

With regard to the financial sector, the European Central Bank has warned that unless the EU accelerates its shift towards a more sustainable future, the credit risk for banking and financial institutions in the euro area may double by 2030 relative to 2022.[34] The risk of inadequately adapting to the transition is also reflected in the views of large European companies that consider that the primary climate-change related risks they face arise from the transition to a net zero economy.[35]

It is clear that even in challenging circumstances the benefits of transition outweigh the costs. It will be crucial for the EU to equip economic actors with the necessary policy signals, tools and incentives to navigate the transition, and to integrate social considerations into its approach.

[31] IMF, November 205, **The Managing Director’s Statement on the Role of the Fund in Addressing Climate Change**

[32] According to the words of Christine Lagarde, President of the ECB, autumn 2021, **The Green Deal is the new social contract**

[33] European Commission, February 2024, **Securing our future – Europe’s 2040 climate target and path to climate neutrality by 2050 building a sustainable, just and prosperous society**, p.28. In addition, there arise additional public financing needs to foster resilience against climate impacts, including investments into climate adaptation.

[34] European Central Bank, September 2023, **The Road to Paris: stress testing the transition towards a net-zero economy** (PDF)

[35] When asked about the main impact of climate change on business, two-thirds of 90 large firms surveyed pointed to transition risks, and half to physical risks stemming from climate change. European Central Bank, 2022, **The impact of climate change on activity and prices – insights from a survey of leading firms**

What the EU can do to ensure financing for a successful transition in 2024–30

The next five years are critical as we approach 2030. Europe's policymakers must make the most of this closing window of opportunity and enable delivery of a successful sustainable transition. Considering the EU's achievements over the past few years, but also the significant gaps and challenges that it still faces in fully financing the transition, we recommend that over the next five-year political cycle policymakers focus their efforts on:

1. **Fully delivering and consolidating the EU's approach to mobilising high-quality private sector finance** so that much greater private sector investments can be mobilised for economic activities that are compatible with the transition.

   This can be achieved by adopting changes to the existing EU regulatory framework, including relevant pieces of EU legislation, by making targeted efforts to fill policy gaps, and by consistently promoting high-quality sustainability standards in member states.

2. **Deploying public finance effectively and at scale to accelerate the transition**, utilising the range of public finance tools, channels and policies at its disposal, including fiscal and monetary instruments, and maximising opportunities to leverage much greater amounts of private finance.

   These policies will need to be accompanied by effective governance of deployment and absorption mechanisms, to ensure compliance across the EU and to set the overall direction of travel for investments for the prosperity and resilience of the EU.

The following chapters expand on these recommendations.

CHAPTER 1

MOBILISING PRIVATE SECTOR FINANCE

Towards a harmonised sustainable finance regulatory framework

The European Union (EU)'s transition to a future that is sustainable, climate-neutral, socially fair, resilient, nature-positive and prosperous rests on its ability to facilitate a regulatory framework that channels unprecedented investments towards sustainable activities. To secure the additional €620bn annual investments needed to achieve the European Green Deal (EGD) objectives[36], it is vital to align private sector activities and finance with these objectives, in synergy with efforts from the public sector (see Chapter 2).

Achieving this goal rests in large part on the EU's ability to regulate and set up effective normative frameworks that can leverage available financing capacity from private entities. The EU has well-developed technical skills and a track record of leadership in promoting ambitious sustainable finance legislation, and it is essential that it continues to do so in the future by pursuing *smart* and *better* regulation.

Over the last five years, the EU has been at the forefront of advancing regulatory policies and tools to facilitate private investments in sustainable activities and support the overall economic transition. This work has mostly focused on enhancing transparency on sustainability matters at company, benchmark, and product levels, and creating new tools such as the EU taxonomy and a standard for green bonds.

Despite progress, more action is required to move beyond disclosures and provide stronger incentives to re-direct and channel private financial flows towards the sustainability objectives, support companies and financiers in navigating the ongoing transition, and complete as well as optimise the current sustainable finance regulatory framework.[37] The EU's resilience will depend not

[36] European Commission, October 2023, **State of the energy union report 2023** (PDF)

[37] EY, May 2023, **Foreign direct investment in Europe stalls amidst economic uncertainty**

only on its ability to establish and implement precise, predictable rules, but also on its capacity to access and use additional sources of capital available on the capital markets and through the savings and venture capital of Europeans. As repeatedly voiced by financial industry leaders, for the sector to best serve communities, consumers and the economy and contribute to the transition to net zero, it is critical to ensure that the sustainable private finance regulatory framework and its implementation are effective, coherent and predictable over the long term.[38]

Six policy objectives to mobilise private finance

This chapter primarily addresses the need to harmonise, build coherence in, standardise and implement current legislation. Doing so will improve the mainstreaming and transparency of sustainability-related data, ease the marketability of sustainable financial products and services, and mitigate sustainability-related adverse impacts and financial risks.

This can be achieved with targeted changes to the existing EU policy framework and relevant pieces of EU legislation, as well as targeted additional efforts to fill the gaps.

> Policy consistency, in these terms, will mean less burden for companies, more effectiveness and impact to reach the interim and 2050 sustainability targets, and more credibility for the EU overall.

The chapter is structured around six policy objectives that are critical for the economic transition. We discuss progress already made, and put forth targeted policy recommendations to advance each objective:

1. Channelling investments for an effective transition
2. Ensuring consistency and effectiveness of sustainability reporting
3. Removing obstacles for consumers to invest sustainably
4. Setting strong standards for due diligence and engagement by financial institutions
5. Accounting for climate and sustainability risks

[38] See presentations from the **EY Sustainable Investment Summit**, 24 January 2024

6. Enhancing accountability and sustainability expertise in corporate governance practices.

All six recommendation areas in this chapter are supported by technical proposals detailed in the Annex. Figure 4 provides an overview of how the six objectives relate to existing and proposed EU policies and regulations.

The chapter ends with reflections on three cross-cutting areas: the capital markets union (CMU), the EU's external role on sustainable finance, and biodiversity.

Overarching recommendations to the European Commission

> Review the sustainable finance strategy, which dates back to July 2021.[39] Some actions were delivered, but others not yet. It should be updated and set out the next steps up to 2030 to ensure the delivery of commitments and fill the gaps.

> Put in place "a robust monitoring framework and a set of indicators to measure capital flows to sustainable investments", as committed to in the above-mentioned strategy, to better assess and annually monitor the funding gap to achieving EU 2030 targets.[40] The European Commission's Platform on Sustainable Finance is expected to make a framework proposal in 2024.

[39] European Commission, July 2021, **Strategy for financing the transition to a sustainable economy**
[40] Action 5(b) of the strategy.

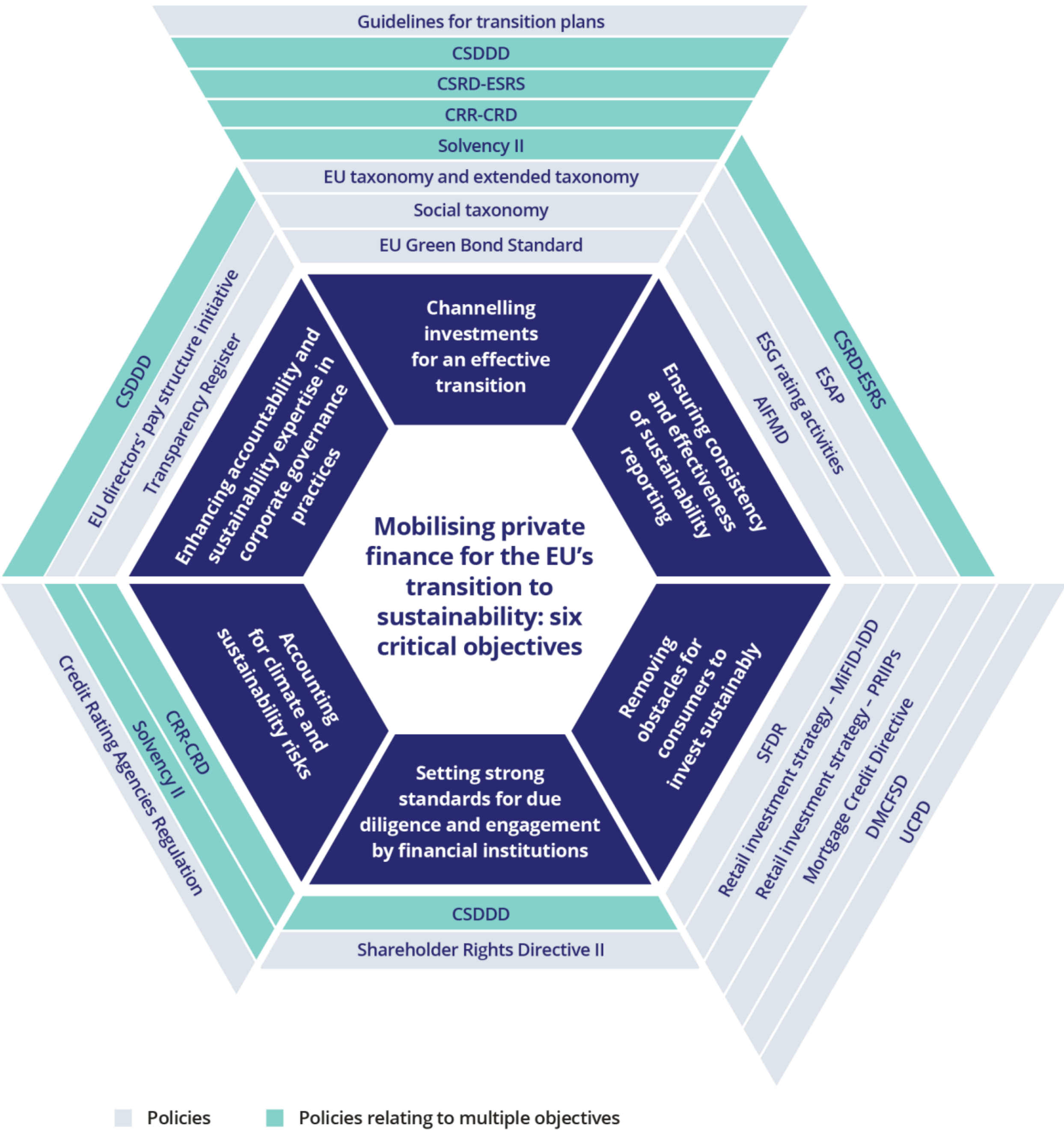

Figure 4: Six critical objectives for developing the EU's financial framework to more effectively mobilise private finance towards the transition. Achieving these objectives relies on further developing the EU's existing, already well-developed finance policy framework in a smart way. This chapter sets out targeted changes and additions needed to the policy framework.

Objective 1: Channelling investments for an effective transition

In the past years, the EU has emphasised promoting investments in sustainable economic activities ("green finance"), but has made limited efforts to encourage investments in economic activities that focus on *becoming sustainable*, i.e. the transition. Investments, in the form of transition finance, need to be stimulated to accelerate change in the real economy. However, the current legal framework provides insufficient clarity and incentives for the financial sector to be able to structurally contribute to the transition to more sustainable economic activities. This not only hinders the EU's potential to achieve its climate and sustainability goals, but also largely fails to address the risks and impacts for both financial and non-financial companies. For example, the European Central Bank has found that most larger companies consider transition risks as the main climate-related financial risk[41], and that if the transition is not accelerated today, the credit risk of banks in the euro area can double by 2030 compared with 2022.[42]

Transition plans are an essential tool for corporations to decarbonise their business model, make them more risk resilient, and attract transition finance in doing so. As outlined in the Commission's recommendation on transition finance[43], a transition plan is a time-bound strategy that outlines how a company translates its environmental targets into implementing actions and investment plans, with the ultimate goal of aligning its entire structure and activities with the 1.5 °C limit of the Paris Agreement and supporting an overall economic transition.

However, multiple shortcomings in EU policies prevent corporate-level transitions from accelerating. For example, different EU regulations provide a mosaic of transition plan-related obligations: some feature requirements for reporting, others for target-setting and implementation, and still others focus solely on financial risk management. The absence of clear, consistent and coherent guidance and structure leads to legal unclarity and administrative

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[41] European Central Bank, 2022, **The impact of climate change on activity and prices – insights from a survey of leading firms**, *ECB Economic Bulletin*, Issue 4/2022

[42] European Central Bank, September 2023, **Faster green transition would benefit firms, households and banks, ECB economy-wide climate stress test finds**

[43] European Commission, 27 June 2023, **Recommendation (EU) 2023/1425 on facilitating finance for the transition to a sustainable economy**

burden, hinders company efforts and progress, and complicates the financing of the transition.

Moreover, the EU lacks a comprehensive transition finance framework[44] that defines not only sustainable activities, but also those that have the potential to become more so, and those that never will (that is, unsustainable activities that must be decommissioned). Such a classification system would clarify and enable larger-scale transition finance.

To address these issues, we propose that policymakers focus on the following goals:

> Streamline the reporting, target-setting, adoption and implementation requirements that are currently spread across several EU regulations, to ensure transition plans are consistent, ambitious, effective and science-based, and cover both sustainability impact and risk management (Figure 5).

> Further develop the EU taxonomy to cover more economic activities and update existing criteria to ensure robustness and expand the EU taxonomy to encompass unsustainable and "intermediate" activities.

> Develop a social taxonomy to define socially sustainable activities and foster investments into sustainable economic activities more widely.

> Improve the EU Green Bond Standard by ensuring all underlying assets in green bonds are taxonomy-aligned and consider making the standard mandatory.

Below are recommendations for how to achieve these goals.

Recommendation 1: Establish a single mandatory transition plan framework to streamline reporting, target-setting and implementation requirements

The framework should apply to financial and non-financial companies alike, and include financial risk management obligations that are currently set out in prudential plans. This recommendation has the highest priority, as it would resolve the current legal complexity arising from EU regulations covering transition-related requirements.

[44] E3G, November 2022, **Achieving a transition finance framework in the EU**

Streamlining transition plan regulation

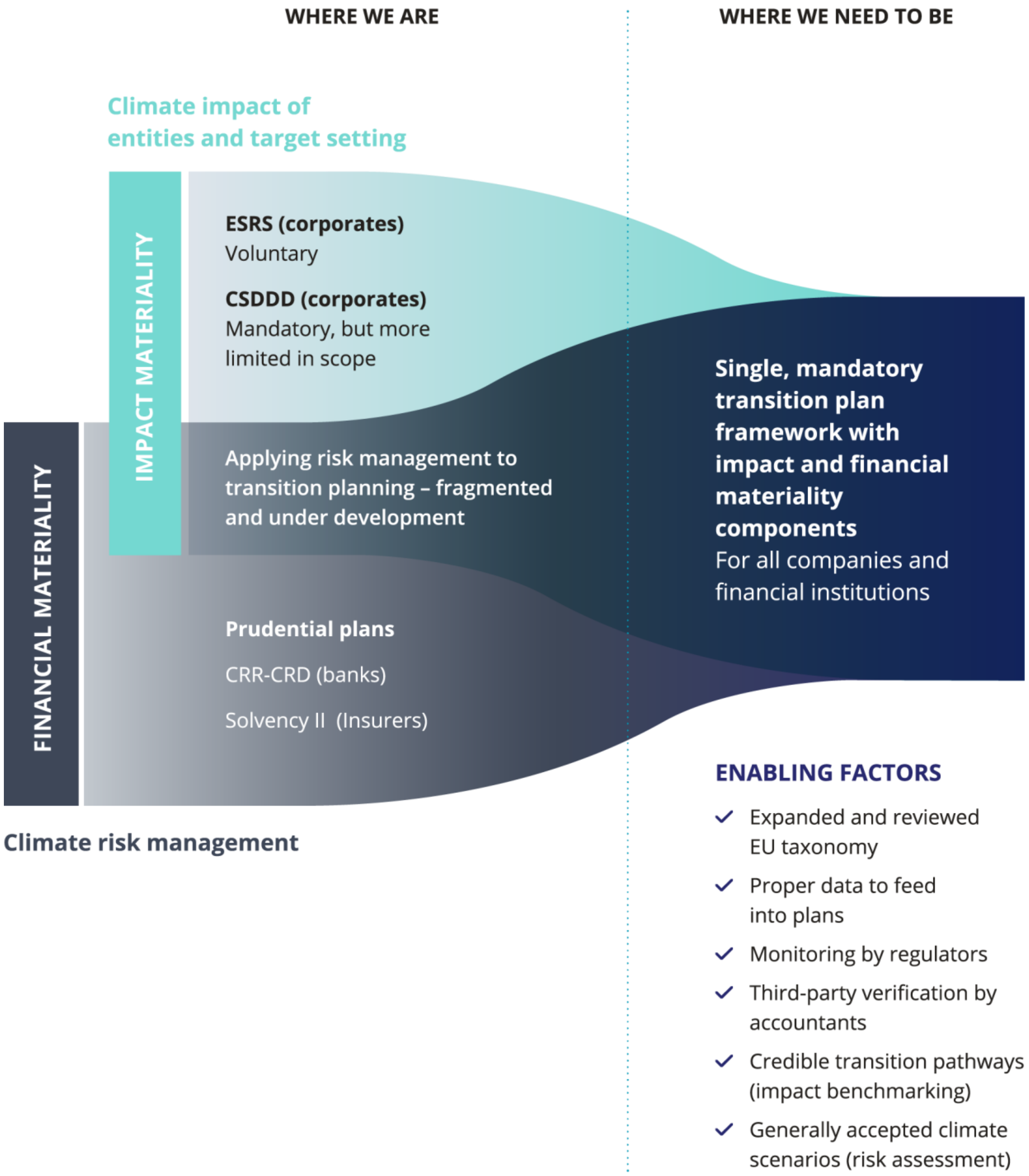


Figure 5: Reporting, target setting and other requirements relating to transition planning are currently spread across several EU regulations, complicating the financing of the transition. Streamlining the framework will support more effective transition planning.

Crucially, this framework should be based on the double materiality principle, requiring companies and financial institutions to assess and mitigate how their operations affect the people and the environment (impact materiality), and how sustainability issues, in turn, affect their financial position (financial materiality). Transition plans should thus explain not only how the company itself will transition, but also how it will contribute to overall economic transition. This avoids the risk of "paper decarbonisation", where companies shift unsustainable assets off their balance sheets by selling them on, rather than by phasing them out.

Mainstreaming and aligning transition requirements across relevant pieces of EU legislation would help companies effectively design and implement plans, support financiers in more effectively considering companies' progress in their financial decisions and portfolios, and ensure coherence in overall approach to the plans.

Two key issues need to be considered in view of the current fragmented state of play: managing and mitigating greenhouse gas emissions and assessing and managing exposure to sustainability-related financial risks.

Requirements for companies to manage and mitigate greenhouse gas emissions (sustainability impact side)

The Corporate Sustainability Due Diligence Directive (CSDDD), which is expected to be approved by the European Parliament and officially adopted in the course of 2024, will require companies to identify, prevent and minimise environmental harm and human rights violations in their operations, subsidiaries and value chains. Article 15 of this law will require all large financial and non-financial companies in the EU to **set climate change mitigation targets**, and **adopt and implement transition plans**.

The CSDDD builds on the Corporate Sustainability Reporting Directive (CSRD) and the related European Sustainability Reporting Standards (ESRS). The latter requires all large EU-based companies and public-interest entities (except for microenterprises), and large non-EU companies operating in the EU, to disclose a transition plan for climate change mitigation if they have one, unless they can demonstrate that climate is not a material topic for their activities.

Consistency between the CSDDD and CSRD will be ensured by allowing companies that adopt a transition plan as per the CSRD reporting requirements to be exempt from the obligation to adopt a plan in the CSDDD. The CSDDD, however, will impose the obligation to all larger companies in scope, including those who can argue that climate issues and thus transition plans are not relevant to their operations.

The transition plan requirements in the CSDDD, though, are limited to climate change mitigation, which is inconsistent with the more holistic objectives of the European Green Deal. It also fails to meet the needs of companies and sectors to whom biodiversity, water use and other sustainability issues are at least as important as climate change. Without a well-devised plan to reduce adverse material sustainability impacts and risks in a systemic and holistic way, companies will be inadequately equipped to effectively navigate the transition.

Considering the above, policymakers should, once adopted, expand the scope of transition plans in the CSDDD from climate only to environmental or sustainability issues more broadly in the general review of CSDDD.

Building on the Strategy for financing the transition to a sustainable economy, **the CSDDD, in its Article 13, will mandate the Commission to issue guidelines on transition plans** for companies and potentially for national regulators to promote effective implementation and monitoring. Such guidelines are critical to support companies to set climate targets and adopt as well as implement transition plans compatible with a 1.5 °C pathway under the upcoming CSDDD, and to disclose sustainability targets under the CSRD. To ensure meaningful targets and plans, lower implementation burden for companies, and ensure robust enforcement of the laws, such guidelines should notably clarify three issues:

1. What reference climate scenarios and sectoral pathways companies should use to set their 1.5 °C-compatible climate targets and transition plans. There is a growing number of available scenarios, and no EU guidance to date for companies to select the relevant one(s), creating confusion.
2. What methodologies firms should use to set science-based targets, on climate change in particular. WWF's recent report finds that the methodological requirements for target creation, submission and validation by the climate Science-Based Target initiative (SBTi) correspond to the requirements set by the CSRD and CSDDD for climate target setting and disclosures.[45] EU institutions and member states, and relevant regulators and supervisors, should therefore recommend that companies and financial

[45] WWF, February 2024, **Corporate Climate Targets – Ensuring the credibility of EU-regulated commitments** (PDF)

institutions set SBTi-validated climate targets to ensure compliance with CSRD and CSDDD. In parallel, the EU should develop a methodological reference framework for corporate climate target setting aligned with the 1.5 °C limit of temperature increase, the use of which should become mandatory over time.

3. How companies should develop and implement their transition plan, in full alignment with the ESRS reporting structure on the adoption side, and the CSDDD on the adoption and implementation side, incorporating elements also from prudential plans (see next section).

Requirements for companies to assess and manage their exposure to sustainability-related financial risks in prudential plans (financial risk side)

The Capital Requirements Regulation and Directive for banks (CRR-CRD) and the Solvency II Directive for insurers require companies to develop plans to better assess sustainability-related financial risks that could affect their financial stability.

To create the right incentives for financial institutions in their prudential regulation, we recommend:

> Fully implementing corporate reporting standards in the CSRD and related ESRS so that companies and financial firms can better understand and manage company-level sustainability impacts and risks.

> Requiring financial companies to develop prudential plans that are based on the information collected, have the same structure, and use sector-specific metrics to ensure meaningfulness and comparability.

> Requiring financial companies to integrate their prudential plans smartly into one single transition plan at entity level, which articulates the double materiality to ensure synergies, considers all material issues (climate, biodiversity, human rights, etc.), and connects the asset, activity and entity levels.

> **Developing European Banking Authority (EBA) guidelines for CRR-CRD and European Insurance and Occupational Pensions Authority (EIOPA) guidelines for the Solvency II Directive**, to specify how prudential plans should cover sustainability-related financial risks in a way that complements CSDDD requirements, with CSRD and ESRS as the foundational structure.

Additionally, to ensure the credibility of both transition plans and prudential plans, **policymakers should**:

> Ensure that auditors providing limited assurance to CSRD reports have the relevant capacity and sustainability expertise to audit both transition and prudential plans, assessing the completeness of information and plausibility of the plans and embedded sustainability targets, and annual progress reporting to assess the consistency of actions with the initial target(s).

> Require and enable regulators and supervisors for each relevant legislation to monitor and assess the plans' credibility, progress as reported by companies, and implementation. This should include building internal assessment tools and sanctioning inadequate plans and targets or lack of adequate efforts to implement them.

Recommendation 2: Further develop and expand the EU environmental taxonomy, including new categories for intermediate and unsustainable activities

A cornerstone of the EU sustainable finance agenda is the EU taxonomy framework, which defines and advances transparency on which economic activities are environmentally sustainable. A science-based EU taxonomy is therefore a prerequisite for promoting green investments in a robust way.

The current state of play of the EU taxonomy reveals significant challenges. Several existing criteria[46] such as both "substantial contribution" and "do no significant harm" (DNSH) need an update, as they are either becoming obsolete or are not stringent enough. In addition, some criteria are challenging to implement because of understandability or usability issues. For example, the Energy Performance of Buildings Directive recast has made taxonomy criteria for building renovation obsolete. Criteria for forestry or bioenergy are among those that have been heavily criticised for not being scientifically robust.

In addition, numerous economic activities are still missing from the taxonomy, limiting the investible universe. This also comes with a lack of diversification for investment and introduces distortions across companies and sectors regarding their alignment with the taxonomy. Specific sectors and companies, which are excluded from the taxonomy but could be fundamental for the environmental transition, are hampered in their ability to gain traction.

[46] Such as Substantial Contribution and "do no significant harm".

In light of these gaps, **policymakers should**:

> Further develop the environmental taxonomy to encompass a broader range of economic activities.[47] The stakeholder interest and market demand for such developments is confirmed by the Commission's dedicated "taxonomy stakeholder request mechanism".[48] We recommend adopting the criteria for additional activities prepared by the Platform on Sustainable Finance.

a) In particular, introduce criteria for activities related to the decommissioning of unsustainable assets. This is essential for a holistic approach to sustainability.

b) Tighten climate criteria to ensure alignment with the latest developments of climate legislation. The review of criteria by the EU Platform on Sustainable Finance – including DNSH criteria – is an opportunity to improve both ambition and usability.

c) Include small and medium-sized enterprises (SMEs) within the scope of taxonomy reporting for financial institutions in order to incentive financial institutions to support SMEs to green their business and in turn to push SMEs to report their taxonomy alignment.

> Expand the environmental taxonomy to clearly define:

a) "Intermediate" activities that clarify and accelerate the transition at company level and improve their sustainability impact within set timeframes (such as energy renovation of existing buildings).

b) Environmentally unsustainable activities that cannot transition. Such activities (for example, thermal coal mining) need to be decommissioned in a timely fashion and their expansion must stop immediately. It is critical to bring investments into these harmful activities to an end.

In September 2023, France and Germany published a joint French–German roadmap for the capital markets union which states on the EU taxonomy: *"We see the need of complementing the EU Taxonomy with economically important activities related to transition, which have been neglected so far. More generally, the sustainable finance framework should foster the allocation of financial flows to transition efforts. The EU Taxonomy framework could be extended to achieve*

[47] The recommendations are further detailed in a joint letter by civil society organisations sent to the Commissioner for financial services Mairead McGuinness on 14 December 2023. 14 December 2023, **Setting next steps to develop the EU taxonomy, Joint letter to Commissioner McGuiness** (PDF)

[48] European Commission, **EU taxonomy stakeholder request mechanism** (webpage, accessed March 2024)

this aim".[49] The final report from the EU Platform on Sustainable Finance on the taxonomy extension is a robust basis that the EU should build on.[50]

Recommendation 3: Develop a social taxonomy to define socially sustainable activities and foster investments into broader sustainable activities beyond only green

So far, the EU taxonomy is limited to environmentally sustainable activities; it does not focus on socially positive activities nor cover sustainable activities more widely.

The initiative of a social taxonomy has been part of the EU's sustainable finance agenda but is yet to be developed.[51] As part of the Taxonomy Regulation, the Commission was required to publish a report to extend the taxonomy to include other sustainability objectives, including social objectives, by 31 December 2021, but this was not carried out.

To facilitate the channelling of resources to promote human rights and social objectives to the benefit of consumers, workers, and communities overall the **next European Commission should**:

> Expand the taxonomy framework to define socially sustainable activities and harmonise terminology and concepts already included in existing provisions to refer to it.

> Go beyond the taxonomy's minimum safeguards to ensure climate and environmental efforts do not have unintended harmful impacts on people and societies.

> Provide financial institutions with guidance on how to comply.

Alongside the completion of the taxonomy regulation as a disclosure framework, more interventionist measures are needed to further push the economy towards more sustainable products and services. These measures, which include stronger green public procurement policies, broader sustainable procurement targets, incentives for public authorities, and targeted tax incentives, are explored more in Chapter 2.

[49] 13 September 2023, **A French–German roadmap for the Capital Markets Union** (PDF)

[50] Platform on Sustainable Finance, March 2022, **The extended environmental taxonomy: Final report on taxonomy extension options supporting a sustainable transition** (PDF)

[51] As per Article 26(2) of the Taxonomy Regulation which sets out that the taxonomy should be extended to include other sustainability objectives, including social objectives.

Recommendation 4: Improve the European Green Bond Standard by aligning it with the taxonomy and making it mandatory

To accelerate the financing of sustainable activities, the EU agreed that a gold standard for green bonds was relevant and developed the European Green Bond Standard. This standard, adopted in 2023, is designed to standardise what constitutes a "European Green Bond", namely financial instruments issued to raise capital for projects with environmental benefits, aligned with the EU taxonomy criteria. The standard is to be used on a voluntary basis by bond issuers.

By December 2026, the Commission is expected to publish a report on the need to regulate sustainability-linked bonds (see Box 1). This could be accompanied by a review of the law if appropriate. **Policymakers should seize this opportunity to**:

> Require that 100% of underlying assets (not 85% as of today) are taxonomy-aligned, as proposed initially by the Commission and the Parliament.

> Assess how the standard should gradually become mandatory to foster the standardisation of robust and transparent green bonds and reduce the risk of greenwashing.

Box 1

Sustainability-linked bonds and loans

Sustainability-linked bonds (SLBs) and loans (SLLs) have grown significantly, serving as versatile instruments for entities to raise general-purpose finance while establishing their key performance indicators (KPIs) and performance targets. Indirectly, SLBs and SLLs could also play a big role in making the capital market union stronger. They could become a stronger and more credible financial instrument if the right principles for identifying the KPIs were followed, and if the environmental targets were science-based. Since SLBs and SLLs are not specifically linked to a project, but rather to the overall performance of an entity, they are more flexible than use-of-proceeds bonds and could play a key role not only at private but also at public level. If well designed in terms of disclosure requirements, SLBs could represent an additional instrument for countries to raise money in the debt market. States could embed climate targets within their bond contracts too.[52]

[52] Bruegel, March 2023, **The potential of sovereign sustainability-linked bonds in the drive for net-zero**

To ensure public and private coherence and ambition while avoiding the risk of greenwashing, an EU common framework is needed for both private and public SLBs and SLLs. Such a framework would help improve the transparency of national policies (as well as related transition scenarios) and companies' targets and transition plans. Additionally, it could support member states and the private sector in identifying and mitigating climate transition risks. A robust EU public and private SLBs and SLLs framework should follow several principles, including the following.

Building on national and/or company-level science-based targets and transition plans

The power of SLBs and SLLs lies in their connection to the underlying targets[53] and transition plans of the issuing entities. Therefore, alignment with 2030, 2040 and 2050 targets for member states and CSRD reporting standards for private entities will play a crucial role in avoiding greenwashing risks linked to SLBs and SLLs, which are by nature more flexible than the EU Green Bond Standard. Therefore, KPIs for SLBs and SLLs should be the ones of a comprehensive transition plan at entity or national level, including emission reduction targets, exclusion of offsets, and alignment with sectoral standards.

The "do no significant harm" (DNSH) principle is respected and implemented with taxonomy criteria

There are inconsistencies in the way DNSH principle is implemented by private and public and private finance. For example, the guidance for Recovery and Resilience Facility (RRF) plans allows the approval of gas projects which are not in line with the Taxonomy Regulation[54]. Once consolidated and more detailed DNSH guidance is developed also at sectoral level (see Chapter 2 below), this principle should also play a central role in defining guidance for SLBs and SLLs. Indeed, both member states and the private sector should commit to aligning with DNSH criteria, which would act as a risk mitigating factor while transitioning and decarbonising. Transition plans should not only be mitigation plans (decarbonisation only), but also encompass considerations related to nature-based negative spillover effects.

[53] Climate Bonds Initiative, 2023, **Sustainability-linked bond database methodology**

[54] European Commission, October 2023, **Technical guidance on the application of "do no significant harm" under the Recovery and Resilience Faculty Regulation** (PDF)

Comprehensive scope of emission targets
Specifically for private entities, 1.5°C climate targets (inclusive of greenhouse gas reduction across all three of Scopes 1, 2, and 3) aligned with science-based sector-specific pathways are crucial for the credibility of SLBs and SLLs. However, as of November 2022, only 14.4% of SLBs addressed all three emission scopes.[55] For example, companies in agrifood and oil and gas sectors must include Scope 3 emissions, which represent a significant portion of their total emissions.

Objective 2: Ensuring consistency and effectiveness of sustainability reporting

Most EU regulations on sustainable finance aim to make the climate, environmental and social impacts of different economic activities more transparent, so that financial institutions (including retail and institutional investors, banks and insurers) can make better informed decisions. However, the several existing disclosure requirements are inconsistent, which has made fulfilling them complicated, and harmed the effectiveness and benefit of the disclosures to companies, financiers and other stakeholders.

To fix the inconsistencies and loopholes, and provide more clarity on specific disclosures, policymakers should:

> Prioritise the development and adoption of robust sector-specific corporate sustainability reporting standards for priority sectors and enhance requirements and reporting quality.

> Enhance and mainstream sustainability disclosure requirements across different pieces of legislation to ensure consistency and effectiveness.

Recommendation 1: Develop robust sector-specific corporate sustainability reporting standards for priority sectors and enhance requirements and reporting quality
To ensure companies and financial institutions are aware of sustainability matters relevant to their operations, value chains and portfolios, the EU has been improving the transparency of both sustainability impacts and risks (double materiality approach). This enables financial institutions to better integrate

[55] Climate Bonds Initiative, 2023, **Scaling credible transition finance - ASEAN**

sustainability-related elements in their financial decisions and provides investors and other stakeholders with a more accurate understanding of companies' sustainability impacts and risks.

The **Corporate Sustainability Reporting Directive (CSRD)** sets sustainability reporting obligations for all large companies with the aim to increase the transparency, comparability, credibility and usability of the sustainability data and combat green- and social washing.

The CSRD is set to be reviewed by 2028 and will be progressively completed via delegated acts, in which EU-wide harmonised **European Sustainability Reporting Standards (ESRS)** will be adopted, based on the work of the European Financial Reporting Advisory Group (EFRAG). Technical work has started and the Commission published the first delegated act in 2023, laying out a first set of sector-agnostic ESRS. While a major step forward, these still have several shortcomings:

> Most of the reporting requirements are subject to a materiality assessment, which dangerously exposes investors to lower availability and comparability of sustainability information.

> There is a lack of clear guidelines for materiality assessment, allowing companies to self-determine which issues are material, thereby risking inconsistent reporting and hindering comparability between companies.

> While companies must disclose the results of their materiality assessment for climate and workforce issues, they are not required to do so for other critical matters, such as resource use.

> Some disclosures are voluntary, such as reporting a biodiversity transition plan and indicators on non-employee workers, which enables companies to select information to report on, potentially impairing stakeholders' ability to make informed decisions.

> There are phase-ins for smaller companies, delaying full implementation, hindering action on environmental and social challenges and limiting transparency and collaboration across value chains during the initial phase-in period.

Following political discussions and on recommendation of the Commission, the Council and the Parliament agreed to delay the adoption of sector-specific standards for eight high-impact sectors from June 2024 to June 2026 at the latest. Although the agreement prioritises stronger transparency in sectors with greater sustainability impacts, the postponement fails to provide sufficient clarity in a timely manner for these and other sectors.

Based on these shortcomings and latest developments, **policymakers should**:

> Adopt reporting standards for eight high-priority sectors, including those already under development (oil and gas, mining, road transport, textiles), as soon as possible, and well ahead of the 2026 deadline.

> Preserve sufficient levels of ambition and granularity in future sets of ESRS, in the absence of improvement, which will be adopted by the Commission via delegated acts. If needed, co-legislators should aim to improve these delegated acts during the scrutiny periods.

> In the next review of ESRS, require companies to disclose cross-cutting or otherwise mandatory sustainability indicators in other EU laws. The indicators that should be made mandatory should include, at least, the Scope 1, 2 and 3 greenhouse gas emissions and indicators required for the reporting of financial institutions, including in the Sustainable Finance Disclosures Regulation (SFDR), Pillar 3 disclosures of CRR-CRD and EU Climate Benchmark Regulation.

> Agree to future reviews of the CSRD to diversify the sustainability assurance market and ensure appropriate sustainability reporting quality.

Recommendation 2: Enhance and mainstream sustainability disclosure requirements across different pieces of legislation to ensure consistency and effectiveness.

Beyond the CSRD and ESRS, policymakers should enhance and mainstream sustainability disclosure requirements across the European Single Access Point, environmental, social and governance rating activities, and the Alternative Investment Fund Managers Directive.

European Single Access Point (ESAP)

Building a fit for purpose, accessible, machine-readable data infrastructure is necessary so that corporate sustainability data can be used to influence decision making. The European Single Access Point (ESAP) will significantly improve the availability of company data for financial market participants. ESAP is a package of three laws aiming to provide centralised access to publicly available information of relevance to financial services, capital markets and sustainability.

ESAP does not create new reporting obligations but introduces a new digital tool (a web portal) that will gradually bring together disclosure requirements from a list of 37 EU directives and regulations, including laws on corporate sustainability reporting. It will ensure that any stakeholder can easily access free-of-charge and comparable information about companies and financial products. It is expected to be available in summer 2027, with a three-step phase-in of available data spread over four years to 2031.

The Commission is expected to write a report on the implementation and effectiveness of ESAP by 2029 at the latest. **Policymakers should seize this opportunity to assess how ESAP is functioning, and include key additional information from upcoming sustainability-related financial legislation in its scope.**

Environmental, social and governance (ESG) rating activities

In the context of the EU's renewed sustainable finance strategy, in June 2023 the Commission published its proposal for a regulation on the transparency and integrity of ESG rating activities, which is still to be formally adopted as of March 2024.[56] It is expected to have a review clause in 2028, four years after it enters into force.

This regulation will be a step forward. However, **policymakers should address the following recommendations in the final law and as part of the review process**:

> Introduce minimum quality principles or thresholds for ESG rating methodologies, including mandatory integration of double materiality, capturing both risks and impacts.

> Separate at group level ESG rating companies from financial services companies including credit rating agencies, to reduce the risk of conflicts of interests.

> Include ESG data providers in the scope of this regulation, as they remain partly unregulated.

[56] European Parliament, February 2024, **Provisional agreement on the proposal for a regulation on the transparency and integrity of environmental, social and governance (ESG) rating activities** (PDF)

Alternative Investment Fund Managers Directive (AIFMD)

The AIFMD, adopted in 2011, establishes a harmonised regulatory framework for the management and supervision of alternative investment fund managers operating within the EU. It aims to enhance investor protection, market transparency, and systemic stability while promoting the cross-border marketing of alternative investment funds.

To align with major disclosure updates in other EU pieces of legislation, **the Commission should make sure that the review of the AIFMD, which is expected by no later than 2029, is used to better include sustainability considerations, including on remuneration structures**. This is necessary to ensure a level playing field and avoid market distortion that could unduly benefit AIFMs if they have lower reporting requirements.

Objective 3: Removing obstacles for consumers to invest sustainably

Sustainable investing for consumers, small companies and other market participants is currently challenging in the EU due to the prevalence of issues such as greenwashing and “social washing”. These deceptive practices involve misrepresenting investment products as more environmentally or socially responsible than they truly are. This poses a significant obstacle for consumers who seek to invest in a sustainable manner, and even more so for retail investors who often face difficulties verifying the authenticity of sustainability claims due to information asymmetries and skewed incentive structures where financial advisors may prioritise their own commissions over consumer interests.

This leads to missed opportunities for financing the green transition and the achievement of EU environmental and social goals. To address this pressing issue, the European Commission should take a more proactive stance in tackling deceptive practices to rebuild trust and foster a genuinely sustainable investment environment.

Policymakers should therefore:

> Create a mandatory product categorisation system that includes minimum mandatory criteria for sustainable investment products.

> Strengthen sustainability provisions in the retail investment strategy.

- Better define and integrate sustainability into product and sectoral legislation such as the Mortgage Credit Directive, Distance Marketing of Consumer Financial Services Directive and Unfair Consumer Practices Directive.

Recommendation 1: Create a mandatory product categorisation system that includes minimum mandatory criteria for sustainable investment products.
The Sustainable Finance Disclosure Regulation (SFDR) was developed to create transparency on how financial market participants disclose sustainability risks and principal adverse impacts at both product and entity levels. Effective since March 2021, it was designed as a disclosure-based regulation but has been misused by fund managers as a labelling regime on sustainable funds, leading to widespread greenwashing risks.

To address this and other challenges, **the European Commission should implement the following recommendations as part of the SFDR review**:

- Make sustainability reporting mandatory for all products, not just those with sustainability objectives. A specific set of a small number of indicators should be defined for all funds. This is necessary to enhance transparency on adverse impacts and remove unfair burdens on sustainable products. In addition, this would contribute to creating a level playing field regarding sustainability reporting obligations and increase comparability across financial products in the EU.
- Develop a mandatory product categorisation system replacing the current Article 8 and 9 framework, which has been used in practice as a label by some in the industry. The new system should have new product categories with minimum mandatory criteria that define what constitutes an investment product that is sustainable, in line with social or environmental objectives, or contributes to either. Specifically, the Commission could create a "transition" category accompanied by science-based criteria to avoid lock-in. These criteria should be tightened regularly (for example every three years) and effectively supervised. The UK Financial Conduct Authority's mandatory regime adopted in December 2023[57] is a good source of inspiration when it comes to product categorisation.
- Ensure consistent entity-level reporting alongside product-level disclosures and develop new engagement disclosure requirements that convey the

[57] Financial Conduct Authority, December 2023, **Sustainability labelling and disclosure of sustainability-related financial information instrument 2023** (PDF)

quality of investor sustainability due diligence and stewardship processes, activities and outcomes.

The review of the SFDR regulation should not be used to postpone the update of the principal adverse impact indicators in the Regulatory Technical Standards attached to SFDR: European supervisory authorities have already finalised their technical recommendations for it.

Recommendation 2: Strengthen sustainability provisions in the Retail investment strategy

With an urgent need for increased funding for the sustainable transition of EU companies, the overwhelming demand of 65–70% of retail investors to invest sustainably[58] is a major opportunity. But a large majority of retail investors are not offered suitable sustainable products because of market failures like information asymmetry.

In addition, financial advisers struggle to implement the new obligation to ask for sustainability preferences from their retail clients, notably because there is limited guidance from the Commission and the European supervisory authorities. More detailed guidance, for example in the form of a template questionnaire, would provide legal certainty for financial advisers, more clarity for retail clients, and a level playing field ensuring more homogeneity in the EU single market. Positively, there is a robust precedent: the think tank 2° Investing Initiative has already coordinated a multi-stakeholder initiative which published such a template questionnaire.[59]

Research found that many financial advisers have no sustainability expertise, while they increasingly advise clients on sustainable funds. Training is therefore necessary.[60]

Finally, there is a conflict of interest between the consumer and the adviser if the latter receives inducements for selling specific products, creating biased advice.

In 2023, the Commission tabled the long-awaited Retail Investment Strategy (RIS), which includes two legislative proposals: an Omnibus Directive including amendments to the Markets in Financial Instruments Directive (MiFID) and Insurance Distribution Directive (IDD), and a proposal amending the Packaged

[58] 2° Investing Initiative, March 2020, **A large majority of retail clients want to invest sustainably** (PDF)

[59] Ibid.

[60] FT Adviser, 21 October 2020, **Half of advisers untrained in ESG despite looming rule change**

Retail Investment and Insurance-based Products Regulation (PRIIPs) key information document (KID). This strategy will not be finalised before the European Parliament elections in June 2024.

The PRIIPs KID introduces a section on sustainability information (as recommended by the European Supervisory Authorities), which is necessary to ensure clear, standardised and accessible sustainability information that retail investors can consider. However, the Commission's proposal is currently incomplete.

Therefore, policymakers should:

> Make sustainable funds the default option for retail investors through a targeted amendment in MiFID-IDD to reverse the "opt in" option for sustainable funds. This can build on a successful legislative precedent in France.[61]

> Develop a delegated act to help financial advisers ask about their clients' sustainability preferences, in the form of a template questionnaire, under MiFID-IDD.

> Ensure sustainability training for financial advisers, validated by a certificate. The Commission has made a proposal to this end, which should be strengthened.[62]

> Introduce an inducement ban, to ensure consumers get unbiased advice on investment and saving options.

> Include in the PRIIPs KID the critical sustainability information that is already required in other EU laws, in the form of five indicators for funds: taxonomy alignment; coal, oil, gas exposure; whether the fund is under SFDR Article 6, 8, 9; the climate score or degree of Paris alignment; and the Principal Adverse Impacts if any.

[61] L'Info Durable, 6 January 2022, **Fonds durables: de Nouvelles obligations pour les assurances vie en 2022**

[62] European Commission, May 2023, **Proposal for a directive to amend directives 2009/65/EC, 2009/138/EC, 2011/61/EU, 2014/65/EU and (EU) 2016/97 as regards the Union retail investor protection rules**

Recommendation 3: Better define and integrate sustainability into product and sectoral legislation such as the Mortgage Credit Directive, Distance Marketing of Consumer Financial Services Directive and Unfair Consumer Practices Directive

Mortgage Credit Directive

A vast part of the EU lending market is made up of mortgages, which can be effectively designed to accelerate decarbonisation in the real estate sector. Indeed, green loans and mortgages form an important input for more sustainable investment products.

The European Banking Authority (EBA) report from December 2023 on green loans and mortgages[63] provides a relevant starting point to revise the Mortgage Credit Directive. It notably recommends the introduction of EU definitions for green loans and mortgages. In its renewed sustainable finance strategy in July 2021, the Commission committed to the following: "*As part of the review of the Mortgage Credit Directive, the Commission will explore ways to support the uptake of energy efficient mortgages by end 2022*". This is critical to achieving the objectives of the EU Renovation Wave.

The European Commission should revise the Mortgage Credit Directive to:

> Provide clear EU definitions of green loans and mortgages, consistent with the EU taxonomy.

> Support the uptake of green mortgages.

> Set up measures to scale up the financing of the energy renovation of buildings.

Consequently, the introduction of EU definitions for green loans and mortgages should lead to improvements related to the green securitisation of real estate assets, with the potential addition of other classes through the EU STS Regulation (simple, transparent and standardised securitisation).

Distance Marketing of Consumer Financial Services Directive (DMFSD)

The DMFSD is a directive that protects consumers from increased online sales of financial products, as it requires consumers to be provided with a significant amount of information before they are bound by a distance contract or offer.

[63] EBA, December 2023, **EBA report in response to the call for advice from the European Commission on green loans and mortgages** (PDF)

Currently, sustainability information is not part of the information that must be communicated to consumers.

In the next review, which is foreseen by July 2030 at the latest, and could possibly be brought forward to 2028, **the Commission should assess how to introduce sustainability information in the DMFSD**, building notably on the review of SFDR categories of sustainable funds.

Unfair Consumer Practices Directive (UCPD)

Enhanced corporate governance and transparency not only bring social and environmental benefits to supply chains; the benefits extend all the way to consumers, as it also aims to combat greenwashing and social washing.

There are various opportunities coming up to make revisions to the UCPD:

> The recent political deal on the Directive on Empowering Consumers for the Green Transition, which amends the UCPD by including unfair claims based on offsetting in the list of banned practice.

> The scheduled review of the UCPD.

> The Commission's proposal for the Green Claims Directive.

Policymakers should use the reviews of these files to bring additional unsustainable practices into scope, such as purposefully designing products to have a limited lifespan. Down the line, this is important to steward more sustainable business activities.

Objective 4: Setting strong standards for due diligence and engagement by financial institutions

Financial institutions, through their investment, lending and insuring activities, exert significant leverage over a broad range of sectors and business activities. Two levers that financial institutions can use to drive change in the real economy and help address system-level sustainability risks are conducting meaningful environmental and human rights due diligence, and stewarding investee companies. However, current EU policies have a limited impact on promoting consistent and comparable practices.

To address this situation, policymakers should:

> Set mandatory due diligence requirements for financial activities.

> Set more comprehensive due diligence requirements for environmental matters.

> Ensure a higher standard for investor engagement.

Recommendation 1: Set mandatory due diligence requirements for financial activities

The EU has made progress in promoting more systemic and transparent sustainability data, but data is merely a means to an end. The EU still lacks sufficient legal measures to incentivise companies and financial institutions to take concrete measures, using this data, to tackle sustainability impacts and risks and ensure more responsible practices.

The Corporate Sustainability Due Diligence Directive (CSDDD), which is expected to be officially adopted in the course of 2024, will help fill this gap by requiring companies to identify, prevent and minimise environmental harm and human rights violations (that is, to conduct sustainability due diligence) in their operations, subsidiaries and value chains. The law will support firms in addressing sustainability impacts in their decision making, inducing a positive change through their business and financial relations, and mitigating financial risks that often arise from uninformed or neglectful business practices.

Financial institutions will fall under the scope of the CSDDD, but financial activities such as investing, lending and insuring will initially be excluded from the due diligence requirements. This major gap is a missed opportunity to create a level playing field for the financial sector, allowing financial actors to neglect or cause them to miss the relevant impacts and financial risks in their core business, and fail to ensure the completeness and effectiveness of the CSDDD.

The CSDDD will require the Commission to assess the need to impose due diligence obligation on financial activities within a maximum of two years after the law enters into force. As repeatedly emphasised in the negotiations by hundreds of financial institutions, real economy companies, academics, civil society organisations and other stakeholders[64], **policymakers should require financial institutions to incorporate sustainability considerations into their**

[64] Business & Human Rights Resource Centre, December 2023, **Statements show widespread support for inclusion of financial activities in the Corporate Sustainability Due Diligence Directive**

financial activities. This would address the limitations of existing, mostly disclosure-based regulations, ensure alignment with international standards, and harmonise already common market practices throughout the EU.

Recommendation 2: Set more comprehensive due diligence requirements for environmental matters

The expected CSDDD defines adverse environmental impacts that companies must address in due diligence as violations of a limited set of international treaties that are often insufficient by design or enforcement, excluding also the Paris Agreement. This fails to ensure firms are equipped to address sustainability risks and impacts and fuels administrative burden, as it is inconsistent with the CSRD/ESRS and the taxonomy, which define environmental matters comprehensively via wider impact categories, such as climate change, biodiversity, pollution, and others.

Policymakers should take the following steps to resolve these issues, once the CSDDD is adopted:

> Fully include the financial sector, including downstream due diligence rules covering their financial activities, in the scope of the early review clause for the financial sector due diligence in the CSDDD.

> Define adverse environmental impacts in CSDDD in a comprehensive way via impact categories in the general review clause.

Recommendation 3: Ensure a higher standard for investor engagement

There is a need to develop stronger investor and shareholder engagement standards so that investors can more effectively tackle systemic risks through stewarding more sustainable behaviour in the corporations they invest in. The current EU policies in place, primarily the Shareholder Rights Directive (SRD II), have a limited impact on promoting consistent and comparable engagement practices. For example, the guidance provided to investors on disclosures related to their engagement policies and implementation, including voting behaviour, is vague and limited to “comply or explain”. Disclosures are incomparable and the quality of both policies and practices varies significantly, including inconsistencies between public engagements and voting records, which leads to an overall lack of accountability. Further, SRD II was adopted prior to the launch of the sustainable finance action plan, meriting the need for alignment with other key pieces of legislation, such as SFDR, to create a harmonised set of requirements for investors.

Additionally, the scope of SRD II is restricted to shareholder engagement and voting, failing to promote more holistic engagement practices for investors and financiers to pursue more risk-resilient and responsible portfolios and economy. This limited scope omits investors' influence over entities they are financing via non-listed equity or fixed income instruments, or over other stakeholders relevant to inducing a more informed and responsible economic system, such as policymakers, industry groups, standard setters, affected communities, CSOs, and others. Such a narrow approach also fails to cover practices like leveraging roles on and nominations to boards, litigation, or engagement with the wider stakeholders listed above.

Policymakers should therefore revise SRD II and build on the relevant parts of the EU regulatory framework on sustainable finance to:

> Define stewardship to clearly link investor engagement activities with sustainability impacts and clarify what responsible engagement entails. The SFDR Regulatory Technical Standards can provide useful input in this regard. For example, Recital 16 includes guidance on actions financial market participants can take regarding principal adverse sustainability impacts, and Article 8 goes further than SRD II in specifying content to include in engagement policies.

> Enhance disclosures to require investors to publish their engagement plans using a standardised and comparable format that monitors and reports on the status of engagements, discloses voting policy, rationale and results, and includes an escalation policy and sectoral expectations with science-based and time-bound milestones on ESG issues.

> Clarify duties for financial institutions, as well as their directors, to conduct engagement practices effectively in the long-term best interest of the financial entity, the investee companies and the stakeholders affected by the latter, considering the impacts, risks, opportunities and leverage (taking a double materiality approach). This should specify what considering sustainability impacts means in practice across relevant pieces of legislation and should include a duty to ensure that investee and portfolio companies adopt and implement credible, science-based targets and transition plans.

> Develop a more comprehensive framework equipping investors and financiers with a) wider engagement requirements that also cover hedge funds, fixed income and private markets (for example, private equity, real estate), and b) incentives to pursue engagement practices more holistically

(leveraging influence over boards, engaging with relevant non-investee stakeholders like policymakers, industry groups and others, and the like).

> Remove obstacles to promote collaborative engagement on a wide set of sustainability matters, including by providing guidance on the issue to investors and via a review of rules on remuneration policies.

> Ensure that supervisors have a mandate to monitor sustainability engagement and enforcement powers over investors.

Objective 5: Accounting for climate and sustainability risks

While sustainability-related considerations have gradually been introduced in the European legislative framework regulating investors' behaviour, the EU has so far failed to adequately recognise the risks of financing activities that cannot or do not transition at a sufficient pace, that destroy nature, or that undermine human rights and other social objectives. This exposes financial entities to widespread financial risks, and will build up financial stability risks.

So far, measures taken at EU level under the Capital Requirements Directive (CRD) and Regulation (CRR) for banks and the Solvency II Regulation for insurers have aimed to ensure that transition risks are accounted for within entities' risk management systems. Increasingly, but not systematically, financial market players such as investors and banks have been required to consider the risks that their own investments and activities generate for people and the planet. While this has achieved a shift in perspective, action needs to be taken now urgently and permanently to reflect the risks associated with business activities that are not compatible with the EU climate and sustainability objectives, and thus are at high risk of being stranded.

Therefore, in the next mandate policymakers should:

> Reflect the risks of activities that are not aligned with the EU climate objectives in the risk-based capital requirements, which would raise their funding costs and require financial institutions to maintain more capital for such investments.

> Ensure that credit ratings adequately integrate sustainability risks.

Recommendation 1: Reflect the risks of activities that are not aligned with the EU climate objectives in the risk-based capital requirements

The link between sustainability factors and financial stability risks is well established within the EU's sustainable finance agenda. The main (but not only) transmission channel for such risks are stranded assets. Investments in assets that might rapidly lose value, such as those related to fossil fuels, are a financial stability risk because the sudden loss of asset value might lead to contagion in the financial system. This is, for instance, because the assets are used as collateral between financial institutions.

Following reception of a specific mandate during the Solvency II review, the European Insurance and Occupational Pensions Authority (EIOPA) published research and analysis exploring the differentiated prudential treatment of assets exposed to sustainability risks and proving this by showing evidence for a differentiated and elevated risk profile of fossil fuel-related stocks and bonds.[65] The outside-in impact of sustainability risks on the financial value of assets therefore justifies making capital requirements sensitive to sustainability risks, either in minimum capital requirement rules (Pillar 1), at the level of individual financial institutions' governance and risk management (Pillar 2) or at the very least through increased transparency about who holds these assets (Pillar 3).

There are strong arguments to recognise climate risks across all three pillars of the prudential framework, including when setting capital requirements under Pillar 1. In this regard, some actors have called for a "one for one" approach, which would mean that for every euro that insurers and banks invest into new fossil fuel-related activities, they should have one euro equivalent of their own funds to guard against risks of stranded assets and related future losses. Although there are no harmonised EU capital requirements for pension funds, supervisory practises can to a certain extent apply a similar intervention logic. Raising capital requirements under this precautionary approach would prevent taxpayers or governments from having to pay the bill for stranded assets by making investors properly account for the full costs, impacts, and risks of such harmful activities, which are incompatible with the EU climate objectives. They would thereby correctly price the risks of financing unsustainable projects, therefore making this less profitable and reducing their market attractiveness.

Considering the above, **the Commission should introduce higher capital requirements for fossil fuel-related assets held by banks and insurers as a first**

[65] EIOPA, December 2023, **Prudential treatment of sustainability risks** (PDF)

important step to properly account for climate and sustainability risks. This precautionary approach is only a first step and would have to be complemented by a range of other measures taken to improve incorporation and assessment of climate risk across all three pillars of the prudential framework (for example, by requiring disclosure of transition plans under Pillar 3).

Recommendation 2: Ensure that credit ratings adequately integrate sustainability risks.

Credit rating agencies (CRAs) are critical actors in establishing and maintaining market norms on financial management and governance by issuers in debt capital markets. The role of CRAs in financial markets is systemic, hence it is critical to ensure that sustainability risks are properly integrated in the development and provision of credit ratings. The CRA market is highly concentrated: the three leading agencies, all based in the US and/or UK, captured 92.1% of the EU market in 2019.[66]

European Securities and Markets Authority's (ESMA) guidelines on disclosure requirements applicable to credit ratings brought incremental changes on sustainability.[67] But further reforms are needed: in 2022, ESMA found a high level of divergence in the disclosure of ESG factors in credit ratings.[68] In its Strategy for Financing the Transition to a Sustainable Economy, the Commission committed to "*take action to ensure that relevant ESG risks are systematically captured in credit ratings and rating outlooks in a transparent manner*".[69]

The European Commission should:

> Clarify how CRAs integrate sustainability factors and climate risk in credit ratings methodologies. This can be achieved with better disclosure requirements on methodologies, stronger monitoring by ESMA on the systematic integration of sustainability factors and longer timeframe of risk assessment in their methodologies, and a requirement to evidence the sustainability competence of staff to the supervisory authorities.

> Clarify how CRAs consider the transition plans of rated companies.

[66] Moody's Analytics, November 2019, **ESMA publishes market share figures for credit rating agencies in EU**

[67] ESMA, March 2020, **Guidelines on disclosure requirements applicable to credit ratings (PDF)**

[68] ESMA, February 2022, **ESMA finds high level of divergence in disclosure of ESG factors in credit ratings**

[69] Action 3 (b) in European Commission, July 2021, **Strategy for financing the transition to a sustainable economy**

> Strengthen the "rating outlooks" – well differentiated from ratings – that apply to all European issuers, to better show how a given issuer is exposed to mid- to long-term sustainability risks.

Objective 6: Enhancing accountability and sustainability expertise in corporate governance

Corporate governance is still too often focused on maximising the short-term wealth of shareholders, often neglecting longer-term sustainability and risk considerations, and the wellbeing of stakeholders more widely. Such an approach can harm the long-term interests of the company and sustainability matters, and have broader negative societal and macroeconomic implications.

There is therefore a need to enhance directors' expertise and accountability towards more sustainable decision making, and make structural changes to corporate governance practices in general. The latter requires improvements in boards' remuneration and composition, stakeholder involvement and shareholders' behaviour.

Policymakers should:

> Ensure that companies' remuneration structures incentivise directors to favour long-term value creation, responsibility and accountability over short-term financial gains, and enhance the sustainability expertise of company boards.

> Better regulate corporate lobbying, which weighs EU policy decision making towards short-term industry interests.

> Engage stakeholders in a debate on corporate purpose to maximise shareholder value.

Recommendation 1: Ensure that companies' remuneration structures do not incentivise directors to favour short-term financial gains

The Corporate Sustainability Due Diligence Directive (CSDDD – see Objective 4 above) carries the potential to align the behaviour of directors and managers with longer-term social and environmental considerations by establishing harmonised rules on directors' duties and ensuring a high level of sustainability expertise for the boards of directors.

To incentivise boards to prioritise long-term sustainability considerations over short-term financial performance, the CSDDD[70] text initially required firms to provide financial incentives to the relevant members of the administrative, management or supervisory bodies in order to promote the implementation of climate transition plans (see Objective 1 above). However, the provision on financial incentives was eventually deleted, limiting the law's ability to integrate sustainability considerations into companies' governance mechanisms.

At least as importantly, the CSDDD could improve directors' accountability for the sustainability of their business decisions. However, while the CSDDD will allow holding companies liable for harmful practices, the ability to hold managers as natural persons legally accountable for the same practices was also eventually excluded.

To ensure stronger responsibility for creating value sustainably, **in the general review of CSDDD, policymakers should:**

> Establish a directors' duty of care, requiring directors to consider the consequences of their decisions for sustainability matters when they act in the best interests of their company.

> Make directors responsible for setting up and overseeing due diligence.

Additionally, several recent reports prove that companies' management teams are inadequately equipped to address the sustainability issues that are material to their operations.[71] This points to the critical need to bridge sustainability skill gaps in boardrooms for the directors to be able to protect companies' long-term interests, meet stakeholders' evolving expectations, and fulfil requirements provisionally set by the CSDDD and other relevant laws.

Although measures to create a legal liability for company directors (directors' duty) have been discussed at EU level, this remains politically challenging, as discussions on the CSDDD demonstrated. The remuneration of management, however, clearly plays a key role in incentivising short-term focus and financial gains, hence the need for an EU strategy to better align societal and private

[70] The version referred to here is the directive text that was agreed in the political negotiations between the European Commission, Council and Parliament in December 2024.

[71] Some examples include a recent PwC report [PwC, 2022, **Charting the course through a changing governance landscape** (PDF)], which showcases that only 25% of board directors say boards understand ESG risks, and a 2024 report by Copenhagen Business School and Competent Boards [Competent Boards & CBS, 2024, **How competent is your board?** (PDF)] showing that only 2% of the largest companies in Europe and the US have high levels of sustainability competency on their boards.

corporate interests. While some of this can potentially be achieved through the transition plan requirements in the CSDDD, a more robust approach would ultimately require structural changes in labour law. Given the challenges of achieving harmonisation at the national level, new EU rules regarding corporate pay structures would have substantial benefits.

In the next mandate, policymakers should therefore:

> Meaningfully link directors' financial incentives and remuneration to companies' progress on sustainability objectives, including in corporate transition plans. In the review of the CSDDD, this means re-proposing the clause, which requires companies to meaningfully link the financial incentives of the relevant governance bodies, including via directors' variable remuneration, to the achievement of the company's sustainability targets.

> Establish directors' duties for sustainability matters, ensuring oversight, responsibility and accountability at the highest level of the company. In the review of the CSDDD, this means re-proposing Article 25 on establishing a directors' duty of care (which requires directors to consider the consequences of their decisions for sustainability matters when they act in the best interests of their company) and Article 26, which could make directors responsible for setting up and overseeing due diligence.

> Assess how sustainability expertise can be ensured in corporate governance. The Commission should gather best practices across European companies, issue a public consultation on the issue, and assess the relevance of amending the CSDDD for this purpose in the planned review.

> Explore a new legislative initiative to make management remuneration increasingly dependent on companies' progress in addressing sustainability impacts, such as an EU Directors' Pay Structure Initiative.

Recommendation 2: Better regulate corporate lobbying, which weighs EU policy decision making towards short-term industry interests

Historically, regulating excessive corporate lobbying of EU institutions has been a complex exercise. It is crucial for policymakers to be able to consult with a wide range of stakeholders, including those directly impacted by current and future policies. Democratic norms demand that such consultation is transparent, and that conflicting interests are balanced.

In practice it can be difficult for official actors to strike this balance correctly. Given the broad scope of policies, and the level of technical detail involved, official actors sometimes do not have sufficient capacity and are highly reliant on inputs from external actors. The external actors who are best resourced to supply these inputs are usually representatives of private sector organisations, and evidence suggests that this has created a space used by industry representatives for intense corporate lobbying that tends not to favour regulation, or the support of low-carbon industries. Improved regulation of lobbying could help to reduce short-term pressure on policymakers.

Considering the above, policymakers should, among others:

- Ensure greater enforcement of compliance with Transparency Register rules.
- Enhance the public disclosure of consultation meetings to include information about who from each side participated in each meeting and what topics were discussed.
- Cap the number of meetings that can be held by European institutions with any single stakeholder over a certain time period.

Recommendation 3: Engage stakeholders in a debate on corporate purpose to maximise shareholder value

A broader European discussion is needed on the issue of corporate governance and the purpose of companies. The concept of maximising shareholder value is pervasive in global business, often interpreted to mean pursuing only shareholder wealth as reflected in current stock prices. For example, the 2012 Kay review of the United Kingdom equity markets heard evidence from company directors who equated their duty to promote the success of the company with maximising current share price.[72] This problem was exacerbated by the fact that the majority of shareholders were passive and often focused on short-term profits, as noted by the European Commission in its 2011 review of corporate governance.[73]

Publicly listed companies are under tremendous pressure from activist shareholders, takeover threats, and market dynamics to generate short-term value by spinning off parts of the company, buying back shares, and laying off staff. In practice, this can create perverse incentives to extract value from the company at the expense of customers, employees, organisational health, the community in which the business operates, and ultimately society as a whole. Unintended consequences that can result include:

[72] Kay, J., July 2012, **The Kay review of UK equity markets and long-term decision making: Final report** (PDF)

[73] European Commission, April 2011, **Green paper: The EU corporate governance framework** (PDF)

- Erosion of trust between society and the corporate sector, in part due to corporations lobbying to shape public policy, which in turn leads to a loss of trust in democratic processes.
- The failure of companies to adequately consider and respond to societal challenges, such as environmental damage and climate change.
- Firm mismanagement, for example through tax evasion.
- Growing inequality in part due to the failure to translate corporate profits into higher salaries across the firm.

Some researchers consider that the move towards stakeholder capitalism is underway but collides with shareholder primacy.[74] At a time of systemic crisis for the existing models of economic development, what companies are designed to do from a societal point of view needs to be rediscussed. In its Purpose of the Corporation Project,[75] Frank Bold raises the following questions:

- How did we get to the current paradigm and do we need to build another one? What are the reasonable alternatives and their associated risks?
- How do we ensure that our companies will continue to have access to capital and continue to provide innovative solutions to meet society's needs? How do we ensure shareholders, and potential shareholders, retain trust in corporations to build wealth, in the new paradigm?
- How do we balance the necessity for corporations to be profitable with their impacts on society?
- What do we understand fundamental concepts such as "competitiveness", "stakeholder", and "value" to mean in this context?
- For whom are corporate managers trustees?
- How might this be reflected in corporate governance provisions and company law?

On the basis of the initial CSDDD exchanges on corporate governance and director duties, **the European Commission should develop a follow-up process addressing the above questions, with multi-stakeholder roundtables and consultations, in order to assess whether company law needs revising**.

[74] Harvard Business Review, August 2022, **Managing shareholders in the age of stakeholder capitalism**
[75] Frank Bold, n.d., **The purpose of the corporation project – concept note** (PDF)

Further recommendations

In addition to the six objectives above, EU policymakers should take forward three cross-cutting areas in the next mandate to holistically address the flow of private finance for the transition to sustainability, both within and into the EU: the capital markets union, external action on sustainable finance, and protecting biodiversity and ecosystems.

EU capital markets union (CMU)

According to the ECB[76] the EU capital markets union (CMU) project needs to transition from a bottom-up only to a top-down strategy.

Currently, the single capital markets project is focused on developing and removing barriers to the further integration of local and regional capital markets. That needs to change to conceive the project as a unified opportunity that not only exists to increase the stability of the monetary union and the resilience of the financial sector, but whose primary function is to finance major economic transformations – such as the European green and digital transition – that exceed the capacities of fragmented financial markets.

This involves taking inspiration from the historical development of the US capital market, where the role of the Securities and Exchange Commission (SEC) was central. Indeed, the absence of a consolidated single market for capitals in the EU is hampering the unlocking of private finance via equity and bond markets along with their potential to bear riskier investments – compared to bank lending – in support of European businesses. ECB advocates a similar approach in the EU today, by strategically strengthening ESMA's regulatory oversight. ESMA's current powers are considered insufficient for the creation of a truly unified regulatory framework. Therefore, a broader mandate is called for – possibly including direct supervision to effectively manage systemic risks arising from large cross-border firms and market infrastructures.

The green transition in Europe would benefit from a robust CMU. Public debt and bank financing alone are not sufficient to meet the estimated over €600 billion annual investment needed to achieve the 2030 emissions reduction targets. Boosting the CMU structure from the start can help ensure more liquid, integrated, and accessible European capital markets, where listed companies have access to more private capital (which is usually less risk averse than bank lending, and therefore more prone to finding marketable solutions). A green

[76] Lagarde, C., 17 November 2023, **A Kantian shift for the capital markets union**, speech at the European Banking Congress

CMU could also facilitate public–private partnerships by channelling flows of savings into sustainable investments and encouraging private money to meet public money to finance the transition if the conditions are right.

However, to cultivate robust and efficient capital markets while growing the amount of capital available for the transition, it is crucial to tap into substantial reserves of long-term capital (such as direct retail investments, as well as private savings). Supporting the possible redirection of such capital from bank deposits to green investments could lead to more significant deployment of capital for the European transition. A reallocation of savings could be achieved by banning inducements fees to avoid conflicts of interest (as already done in the UK and Netherlands), and offering sustainable products to retail investors, who have expressed strong appetite for these. This heavily links to the retail investment strategy (see Objective 3 above). Moreover, EU risk capital, particularly pre-IPO risk capital, has grown but still represents a fraction of US investments (US pre-IPO risk capital represents 1.3% of GDP, while in the EU it amounts to 0.15% of GDP).[77]

We therefore recommend the following:

> **Further work to increase ESMA's supervisory power and centrality, as well as coordinated intervention capacity (sanctioning) and establishing a single rulebook for EU capital markets highlighting the significance of regulatory consistency.** A single rulebook would be directly applicable to all entities involved in EU capital markets. This unified set of rules should aim to level the playing field, discourage fragmentation, and promote a fair and stable regulatory environment conducive to green, sustainable private investments.

> **EU member states to create coordinated plans to develop their respective green capital markets.** By implementing these national plans, member states can develop insights into effective and ineffective strategies, offering valuable guidance for the development of national and more integrated capital markets. This, in turn, would support harmonisation and a robust financial landscape within the EU. While formulating these national plans, it is crucial to assess the impact of existing EU regulations, identifying both challenges and opportunities (notably concerning private pension schemes, sustainable social entrepreneurship and venture capital for innovative startups). The European Commission should coordinate this process and ensure the exchange of best practices across member states. The primary

[77] European Capital Markets Institute, March 2022, **From NGEU to a Green Capital Markets Union** (PDF)

objective is to empower retail investors (and willing savers) to become more active investors in the green transition.

The EU's external role in advancing sustainable finance regulation

The EU plays a pivotal role in shaping sustainable financial regulations globally. Its proactive stance in sustainable finance policy is therefore crucial for setting global standards and fostering international collaboration. Considering the global impacts of its financial regulations, and the urgency of redirecting investments towards the transition, the EU cannot rely on a fragmented approach to international policy-setting.

Our overarching recommendation is to make the EU's internal sustainable finance policy development part of a uniform diplomatic strategy. Through coordination between the Foreign Affairs Council (FAC), the European External Action Service (EEAS) and DG CLIMA, INTPA, FISMA and NEAR in the European Commission, the EU should establish a clear mandate for a renewed EU climate foreign policy. Under this mandate, the European Commission and member states should make sustainable finance a diplomatic priority and lead global efforts to drive international financial reforms, for instance at international fora such as the G20, G7, COPs, Network for Greening the Financial System, and Coalition of Finance Ministers. **Enlarging the uptake of ambitious sustainable finance policies and ensuring early-stage international cooperation is key to maintaining the EU's global leadership.**

Driving high ambition

The EU's leadership and collaboration efforts on the taxonomy have been particularly effective in encouraging global alignment with its own standards. Over 40 jurisdictions – including China, ASEAN countries, the UK, Mexico and Canada – are now developing their own sustainable taxonomies, referring to the EU's criteria and framework. The EU's influence led, for example, to significant positive changes in China's Green Bond Catalogue, including the removal of controversial activities like clean coal, and the introduction of the "do no significant harm" (DNSH) principle. Conversely, internal debates within the EU about the sustainable classification of gas-fired power and nuclear power have prompted countries like Korea to reconsider their own standards. **Whether the EU kickstarts a race to the top or to the bottom is thus highly contingent on strong and ambitious rules at home and sound partnerships abroad. The effectiveness of the EU's regulations in driving global sustainability efforts underscores the importance of ambitious domestic policies and robust international partnerships.**

The EU's international cooperation has lagged behind on transition plans in particular. Until now, it has failed to effectively coordinate with jurisdictions that are ahead of the EU, let alone drive the conversations and shape standards and requirements. This lack of cooperation has also been affected by the fragmented regulatory framework around transition finance (see Objective 1 above). **The EU therefore needs to enhance its internal policy coherence, paving the way for effective collaboration with other jurisdictions.**

The evolving global policy landscape, with initiatives like the G20 having focused on transition finance since 2022, highlights the urgency of addressing climate change and sustainability through aligned financial systems. The international landscape for corporate transition plans is rapidly evolving as global recognition of climate change's urgency increases, pushing for financial systems to align with sustainable goals like those of the Paris Agreement. The European Commission, in collaboration with Japan and Switzerland through the International Platform on Sustainable Finance (IPSF) and building on the EFRAG (European Financial Reporting Advisory Group), is contributing to setting global standards for transition finance, also acknowledging efforts from other organisations like the UK Transition Plan Taskforce (TPT), International Sustainability Standards Board (ISSB), and Glasgow Financial Alliance for Net Zero (GFANZ). This global momentum underscores the importance of continued international cooperation to foster a more sustainable economy through harmonised policies and standards.

Aligning international standards

EU financial regulations have global impacts, necessitating a balance between assertiveness and collaborative consensus-building to avoid market fragmentation and diplomatic tensions. Although the so-called "Brussels effect" influences international policymaking, without active, sound and targeted diplomatic effort, it can fall short of establishing a constructive, multilateral dialogue on sustainable finance and development.

Examples include the double materiality approach of the European Sustainability Reporting Standards (ESRS) and the corporate due diligence rules (CSDDD). **Clashes with ISSB over reporting standards are a clear demonstration of the significant challenges and risks to the global coherence and comparability of sustainability disclosures**. The divergence of reporting under single materiality (ISSB; the impact of climate change on an institution's business and operations), as opposed to double materiality (ESRS; the impact of climate change on an institution's business and operations and that business's impact on the environment), creates a complex landscape for multinational corporations.

To move forward, **more work is needed to internationalise the double materiality approach and to support globally aligned standards for impact reporting.**

Moreover, the EU should consider how the international perception of these rules is reflected back on the EU in the form of external pressure and influence over internal EU decision-making. **External influence through lobbying from multinational corporations and foreign business associations has significantly shaped the context in which EU policies and regulatory frameworks have been developed and debated**.[78] Such politically and ideologically charged clashes showcase the need for the EU policymakers and diplomats to collaborate and engage external actors at an early stage to secure support for and alignment of European rules internationally. They also highlight that the EU needs to be mindful of international sensitivities and perspectives when developing new approaches, so that it can predict and prepare for debates and challenges and be most effective in driving progress at multilateral level.

Setting the international agenda

Aside from engaging meaningfully to drive ambition, the EU needs to show global leadership to set the agenda and untangle topics that are more difficult to address, especially by one jurisdiction alone. Climate-related financial risk, in particular how banks and insurers should address climate change as a material risk, is one such topic at a crucial juncture in 2024. Furthermore, the escalating physical risks from the climate crisis, including disasters with global repercussions and the potential for socio-economic and ecological disruptions, highlight the urgent need for financial institutions to develop resilient measures and models to assess and mitigate the impacts on economic stability and societal wellbeing. Addressing the gap in climate-related risk assessment and the resulting geographical and social inequalities requires comprehensive financial regulation and policy solutions to prevent capital flight from vulnerable sectors and ensure equitable disaster risk management. These are topics the EU should consider proactively collaborating on in the international space.
In particular, a consensus has emerged at the global level among prudential authorities (financial regulators and central banks) that climate change is a threat

[78] Examples include AmCham EU demanding significant changes to the CSDDD and to the CSRD/ESRS: AmCham EU, 2 March 2023, **Letter to Commissioner McGuinness on CSDDD** (PDF), and 8 May 2023, **Letter to Commissioner McGuinness on the reduction of reporting requirements** (PDF)

to financial stability due to both physical risks and transition risks, requiring adjustments in prudential requirements, and the European Central Bank (ECB) has played a key role in this. Crucially, in its newly set 2040 decarbonisation target the EU recognises that the financial sector and supervisory authorities need to consider these trajectories when assessing the climate transition risks of investments.[79]

As climate-related financial risk is in the early stages policy-wise, EU leadership and open collaboration at home and abroad will be crucial for creating global momentum around some of the early-stage developments, in particular:

> Reframing prudential disclosure requirements for financial institutions (to include transition plans).

> Reframing the definitions of risk and the mechanisms to assess them more broadly as an imperative to avoiding carbon lock-in effects.

> Improving climate risk modelling and forecasting.

> Better addressing the financial dimensions of physical risk and resilience.

Work is ongoing at the international level on all these topics in 2024, namely by the Basel Committee on Banking Supervision. Continued European leadership and diplomacy in this forum – in particular via the ECB, but also through the EU's participation in key international venues such as the G20 or the Financial Stability Board – is necessary to secure progress on these matters in 2024.

Protecting biodiversity and ecosystems

The resilience and performance of the European economy is dependent on healthy nature. 72% of EU companies are dependent on services that come from the natural ecosystem, such as crop pollination or timber production, and 75% of EU bank loans are lent to highly dependent borrowers.[80]

The EU has signed up to the Convention on Biological Diversity and the targets enacted by the Kunming–Montreal Global Biodiversity Framework. The EU Biodiversity Strategy for 2030 builds upon these initiatives and trickles down into EU legislative initiatives, like the EU taxonomy and the Nature Restoration Law. The key action to achieve the global targets is re-channelling harmful financial flows into projects and activities aligned with nature-positive pathways and

[79] European Commission, February 2024, **Communication on Europe's 2040 climate target and path to climate neutrality by 2050 building a sustainable, just and prosperous society**

[80] ECB, June 2023, **The economy and banks need nature to survive**

attracting investment into nature-based/natural climate solutions, protection of nature, and impactful but unbankable early-stage projects. While €35–40bn of annual flows into EU agriculture are allocated with limited or no sustainability requirements, the investment gap into the EU biodiversity action is estimated at around €19bn a year.[81]

To secure evidence to inform policy and corporate action, policymakers should effectively support the implementation of assessment and disclosure requirements, like the ESRS and the Taskforce on Nature-related Financial Disclosures (TNFD) framework, and invest in traceability and data initiatives, like those implied by the EU regulation on deforestation-free products. In parallel, companies need to set science-based nature targets and transition plans wherever material. It is important to set a clear ambition for nature-related due diligence, as outlined in the CSDDD, and avoid EU investments causing harm in ecologically sensitive locations abroad.[82] Finally, biodiversity-related financial risks need to be properly assessed and integrated in prudential rules, both at the EU level and globally (see the above section).

[81] European Commission, **Environment, Biodiversity financing**, (webpage, accessed March 2024)

[82] WWF, October 2023, **Financial institutions in the EU are driving harm to the environment and human rights**

CHAPTER 2

DEPLOYING PUBLIC FINANCE TO ACCELERATE THE TRANSITION

Public finance needs to work in support of the private finance framework

Private finance and regulatory measures alone will not be able to fill the gap in investment to finance Europe's transition to climate neutrality. In the past we have seen that prescriptive regulation – be it phase-out of gas subsidies for businesses or mandatory replacement of gas boilers for private households – face backlash and resistance. Consumers and businesses may be unwilling to change lifestyles and business practices as they face uncertainty in the transition, especially if it entails upfront adjustment costs from their end.

In this light, the EU must take a critical look at how to leverage its public and private finance flows together and identify the right levers to do so. Even the best regulatory framework needs concrete incentives pointing in the same direction to be successful.

In the next five years, the EU will contend with strategic political, economic, and technical choices on how it can make its public finance levers better serve the goal of achieving a sustainable, just, and inclusive transition. This will happen against a backdrop of tightening public budgets, and in a political context of overlapping priorities for the future of Europe's competitiveness, enlargement, and the broader geopolitical tensions arising from the transition globally. At the same time, this crossroads offers an opportunity to reshape the EU public funding landscape and to channel resources effectively towards sustainability objectives, all while ensuring Europe's global standing and competitiveness.

In this chapter, we first shed light on the political context of the role of public finance in the EU. We ask why we need more public investment, and at the EU level specifically, and where that money will come from. We then consider monetary policy, before discussing effective ways to deploy public funding, including through Europe's development banks, green public procurement, and by applying private finance regulatory tools to public funding (Figure 6).

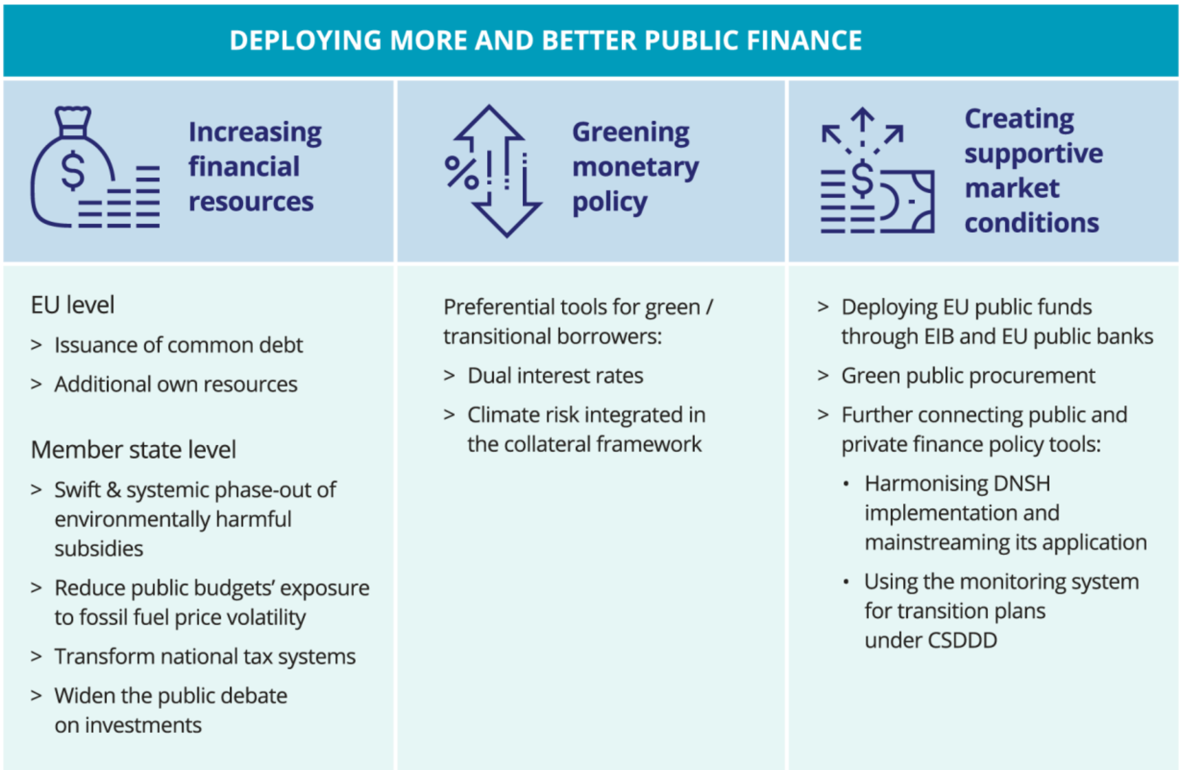


Figure 6: Summary of recommendations for increasing the amount of public finance available for the transition and improving its deployment.

Why we need more public investments

Public investments are crucial to address the transition and to adapt to a new climate reality

Modernising electricity grids, insulating homes, building up charging infrastructure for electric vehicles – investment needs for the transition are mounting. Public funds have an important role to play in achieving the additional €620bn investments per year to meet the objectives of the European Green Deal and REPowerEU.[83]

That number entails both public and private investments, and there are numerous cases where public funding sources are the only viable solution. Home renovations in lower-income regions or investments in sustainable decarbonised public transport networks are prominent examples. Many infrastructure investments such as electricity grids, railways and other transport networks rely on public funding and regulation due to high upfront costs, considerable

[83] European Commission, July 2023, **2023 Strategic Foresight Report** (PDF)

economies of scale and network effects, and relatively low marginal costs. Those characteristics make networks a promising case for publicly financed and publicly regulated goods. Finally, affordable energy, skilled workforce, and modern infrastructure are key enablers for a thriving economy that require support from public investments.

Moreover, **it is key to maintain high-quality public services in times of uncertainty to foster democratic resilience, equity, and social cohesion**. This includes investments to ensure access to good healthcare, education and transport infrastructure.[84] As a case in point, there is an investment backlog of €150bn at the local level in Germany, including nearly €50bn for schools and €40bn for streets alone.[85]

Financial support schemes are needed for affordability and buy-in into a just and fair transition

Beyond the need to finance public investments, the public backlash around the gas boiler ban in Germany in summer 2023 showed that regulatory initiatives without sufficient financial security can backfire and undermine the entire transition project through divisive politicisation against climate policies.[86] For the public to feel they are empowered actors in the transition, financial incentives are not enough – but financial security is a necessary condition. Therefore, progressive financial compensation schemes or below-market interest rates will require public funding support.

Competing for public funding and the new geopolitics: defence spending and rising economic protectionism

In addition to investment needs and direct financial support for the transition, current geopolitical tensions bring additional competing interests for public spending in the realm of security and defence.

Since the Russian invasion of Ukraine in 2022, assistance to Ukraine from the EU and its member states has amounted to more than $88bn.[87] Moreover, 20 EU member states have increased their national defence expenditure, 6 of them by more than 10% compared to 2021–2022. On average, defence spending in the

[84] ECFR, January 2024, **A sharp right turn: A forecast for the 2024 European Parliament elections**

[85] Deutsche Staedte- und Gemeindebund (DStGB), May 2021, **KfW-Kommunalpanel 2021: 149 Mrd. € Investitionsstau**

[86] Politico, October 2023, **How the Far Right Turned Heat Pumps Into Electoral Rocket Fuel**

[87] European Commission, 2024, **EU assistance to Ukraine**

EU grew by 5.9% in this period.[88] These developments drive up public costs and make the allocation of finite public resources more difficult.

Geopolitical tensions and other crises have also had lasting implications for international trade. The COVID-19 pandemic laid bare the vulnerability of global supply chains. In addition, a shift away from trade liberalisation with the appearance of local-content requirements and barriers amid increasing threats of economic warfare could credibly result **in potentially long-term economic protectionism.** Making supply chains more resilient will require a stronger public role to both protect and secure access to resources, and compensate for potential welfare loss due to increased restrictions in trade and global exchange conditions. The realistic possibility of a more inward-oriented US in the aftermath of the 2024 presidential elections makes this scenario even more concerning.

Why we need more EU-level public funding

Not only are public finance and investments important, in some instances especially it needs to come from the EU level. We look at three specific cases where EU public funding is far better suited than national public funding: protecting the single market; financing European public goods; and rising demand for existing EU budget resources.

1. Protecting the single market while responding to mounting international competition

With the adoption of the Inflation Reduction Act (IRA), the United States not only shifted the global landscape for sustainable financing, but also showed that it is willing to use public finance resources (in the form of subsidies and tax credits) to steer private investments towards building low-carbon value chains at home and stir demand for decarbonised products such as electric vehicles. Other countries such as China, Japan, Canada, India and South Korea have also ramped up efforts to advance the decarbonisation of their industries through a combination of regulatory measures and financial incentives.

These international developments have aggravated existing fears that industry will re-localise to other countries to reap benefits of subsidies that are linked to domestic production. As a response, European member states with a strong industrial base (most notably Germany and France) have accessed subsidies

[88] European Defence Agency, 2023, **Defence Data 2022 – Key findings and analysis** (PDF)

themselves to both keep big industrial groups within their countries' borders and attract foreign investment.

The extended use of public funding to support domestic industries was made possible through the November 2023 update of the EU Temporary Crisis and Transition Framework (TCTF).[89] However, it threatens the level playing field within the EU. Documentation on approved state aid exemptions shows that most of the approved state aid benefitted industries in a limited number of countries.[90] The very uneven use of state aid to counter international subsidies from other countries risks skewing competition within the EU. Only member states with fiscal firepower can boost their domestic industries while smaller or fiscally weaker economies lose out and are unable to benefit from the consequent industrial transition.

A coherent EU industrial policy, supported by centrally coordinated, efficiently and fairly allocated EU-level funding, could counter international pull factors on European industries while ensuring that any public funding support maintains the level playing field and fosters intra-EU cohesion and solidarity. However, national governments and individual companies might be hesitant and prefer to boost their industries through national funds. In 2023, we saw that discussions around state aid exemptions had a lasting negative impact on Franco-German relations as both governments feared competitive disadvantages for their domestic industries.[91] An EU-coordinated approach would prevent inefficient subsidies to economic incumbents. In November 2023, the European Committee of the Regions highlighted that relaxation of state aid rules risks widening existing disparities not only between but also *within* EU member states. They advocated for fair competition as an essential to promote innovation and efficient allocation of resources.[92]

2. Financing European public goods

Another important rationale for additional EU-level funding is investment in **European public goods (EPGs)**.[93] This extends the concept of *public goods* (non-rivalry and non-excludability) in three specific ways mindful of and contextualised to the EU's socio-economic characteristics. EPGs:

[89] European Commission, November 2023, **Temporary Crisis and Transition Framework**

[90] Laura Debois, Henry Foy, Ben Hall, December 2023, **More State Aid will not help Europe compete, warns Belgian PM**

[91] Reuters, October 2023, **EU tries to unblock France, Germany spat over industrial competition**

[92] European Committee of the Regions, November 2023, **Prolonging eased state-aid rules raises risk of territorial imbalances in Europe, local leaders warn**

[93] Centre for Economic Policy Research (CEPR), June 2023, **European Public Goods**

- Produce or provide services or goods at European level to maximise positive externalities across all member states.
- Generate mutual interest from member states to exploit cross-border collaboration and maximise output.
- Additionally benefit the Union as a whole, beyond the sum of member states' individual benefits.[94]

A central EU-level financing operational facility would therefore be most suitable for some investments to maximise both their efficiency and utility. Areas that would benefit from EPGs include reducing energy dependence by shifting investments into cross-border energy infrastructure, and increasing the competitiveness of specific EU industries through the common purchase of critical raw materials programmes.

Additionally, EPGs can prove an effective lever to tackle several challenges the EU is currently facing. They could bolster confidence in financial markets and counter fragmentation of the public finances landscape, while providing the foundation for a common industrial policy and ensuring the integrity of the internal market. At the same time, this process would advance the twin digital and climate transition through the development of cross-border projects and create added value beyond the sum of member states' individual environmental, socio-economic value creation.[95]

3. Mounting demands for EU funding through enlargement and repaying EU-level debt

Debates on EU enlargement have raised the question of its financial implications, especially since Ukraine and Moldova were granted official candidate status in late 2023. Research estimates that the accession of a number of countries[96] would add a total annual net expenditure for the EU of €19 billion. However, those estimates result from the current rules, which are subject to political negotiations.[97] The rules may be reviewed and reformed in the upcoming negotiations of the next MFF in 2025.

[94] Bruegel, February 2023, **Shaping the future of the European Union: a discussion on public goods**

[95] Centre for Economic Policy Research (CEPR), June 2023, **European Public Goods**

[96] Ukraine, Moldova, Bosnia and Herzegovina, North Macedonia, Montenegro, Albania and Serbia

[97] Hertie School Jacques Delors Centre, December 2023, **What does it cost? Financial implications of the next enlargement**

In addition, the EU will enter the repayment period of the debt-financed Recovery and Resilience Facility (RRF) with the next MFF, starting in 2028. In times of rising interest rates, those debt servicing payments will impact the MMF. According to an estimate from Bruegel, the total annual financial needs to service this debt could reach between €22 billion and €27 billion in 2030 (50% confidence interval). This would represent 0.11–0.13% of EU GDP. It would then gradually decline towards €13.9 billion in 2058, the end date of the refinancing programme.[98] A key question is whether those payments will be financed through additional funds or cut other budget lines. The outcome of the negotiations on the mid-term revision of the MFF 2021–2027 show that member states currently favour redeployment of existing funds over contributing additional funding.[99]

Where will the public money come from?

Having established that public investments have an important role to play in the transition, the next question is where that money will come from.

There are two principal sources of public funding in the EU: national budgets and EU-level funding. We will look at them in turn, highlighting current challenges and opportunities that arise from the high demand for public finance in the coming years.

Aligning national budgets with the transition

State of play

The outlook for national budgets is dire. The combined effect of the COVID-19 pandemic and the Russian invasion of Ukraine has driven up national deficits and reduced the space for investments. However, while deficit levels within the EU are not particularly high compared to other countries, EU member states have tended to prioritise fiscal consolidation. With inflationary pressures decreasing but still substantial and a slow rebound in economic growth, governments are shying away from raising taxes.[100] Investments consequently lose out, as there is little money available. Without clear political leadership that places investments at the core of a broader programme to strengthen the economy, there is a high

[98] Bruegel, October 2023, **What will it cost the European Union to pay its economic recovery debt?**

[99] Politico, December 2023, **EU's green funds are under the guillotine**

[100] European Commission, February 2024, **Winter 2024 Economic Forecast: A delayed rebound amid faster easing of inflation**

risk of investments with sustainability objectives being postponed further raising costs.[101]

There is public support for debt reduction and consolidation. While the aftermath of the European debt crisis revealed the damaging impact of rigorous cuts in public expenditure and austerity, large portions of European society are currently inclined towards arguments of fiscal consolidation.[102]

As a case in point, the negotiations of the reform of the EU fiscal rules – which have largely concluded as of March 2024 – provide a pessimistic outlook for investments. Stringent rules on deficit and debt/GDP ratios (Figure 7), as well as mandatory numerical debt reduction rules, threaten to become big roadblocks for future-proof investments (see Box 2).

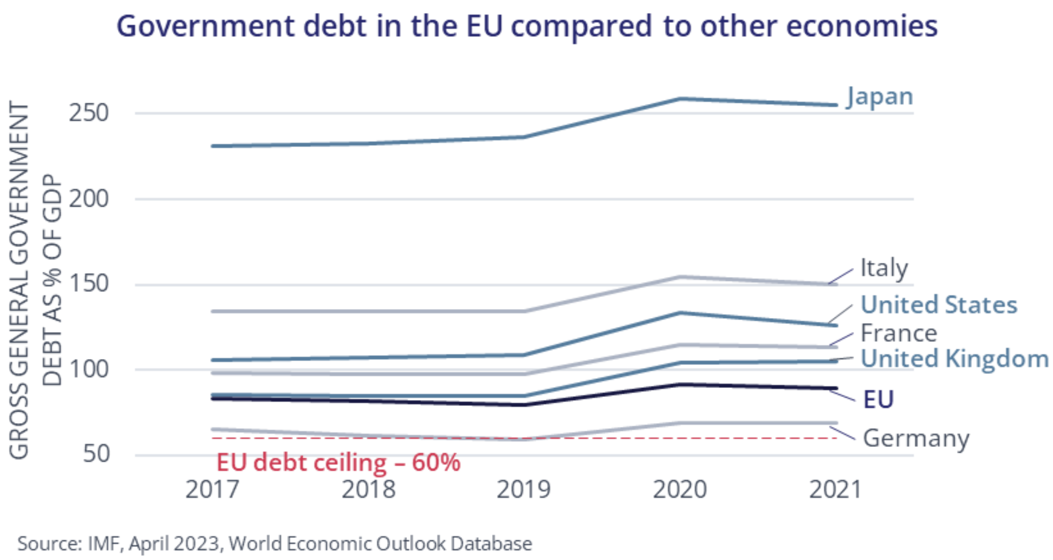


Figure 7: Public debt average in EU member states is not notably high compared to that of other advanced economies. The recently negotiated 60% debt-to-GDP ceiling further limits the ability of EU member states to invest in a transition that is also economically sustainable.

[101] Energy Innovation, January 2021, **The Costs of Delay**

[102] To illustrate this point, fiscal consolidation was a dominant driver in the Finnish parliamentary elections campaign and in Germany we see continuous public support for the federal debt brake that severely limits the government's ability to make new debt; ZDF Politbarometer, November 2023, **Schuldenbremse: Mehrheit gegen Lockerungen**

Box 2

Newly agreed European economic governance framework

Background

The EU’s economic governance framework (“EU fiscal rules”) refers to a set of rules and institutions designed to coordinate economic policies among member states. It includes measures such as the Stability and Growth Pact, which sets limits on budget deficits and public debt, and the European Semester, the framework for economic policy coordination and surveillance. In April 2023, the European Commission presented a legislative proposal[103] to reform the EU economic governance framework as the existing framework was increasingly unfit for purpose. EU member states and the European Parliament reached an agreement in February 2024.

Overall assessment

With those rules in place, national policymakers will face tough decisions about where to cut spending since they lack the political will to raise taxes in fear of political backlash or losing businesses to more attractive fiscal conditions elsewhere. Furthermore, the agreed-upon “common numerical debt and deficit safeguards” risk undermining the initial objective of allowing member states to outgrow debt through quality reforms and investments A positive development is that member states will have to explain how their national debt reduction plan will ensure consistency with the European Climate Law, although there are no further criteria to guarantee the quality of member states’ green public investments.

Main elements

3/60 rule at the core of the framework confirmed

At the centre of the economic governance framework is the 3/60 rule, that prescribes that member states’ budget deficits cannot go beyond 3% of GDP and overall government debt must not be above 60% of GDP. While those reference values have been maintained from the previous EU framework, those are not adhered to internationally. But also domestically, current EU average debt level amount to 89.9%, clearly beyond the 60% ceiling. The rules foresee corrective procedures for those member states in breach of those ceilings.

[103] European Commission, April 2023, **New economic governance rules fit for the future**

Country-specific national medium-term fiscal–structural plans

All EU member states are required to set out national four-year fiscal-structural plan in which they lay out how investments and reforms are responding to the country specific recommendations (CSRs) that originate from the annual European Semester process. Moreover, governments are asked to elaborate how the EU common priorities are addressed, including the consistency with the European Climate Law among other priorities. Member states not in breach with the 3/60 rule can request non-binding technical support from the Commission to set out these plans.

Mandatory reference trajectory for net expenditure paths

Governments of member states with public finances in breach with the 3/60 rule receive **a binding reference trajectory** from the Commission that defines a multiannual net expenditure path to consolidate debt & deficit levels. While this trajectory is country-specific, it is constrained by so-called "common numerical safeguards" that set out annual minimum deficit and debt reduction requirements.

Common numerical safeguards require a minimum annual debt reduction for countries exceeding the 3/60 rule

Countries with debt ratios over 90% of GDP (including Italy, France, and Spain) will have to annually reduce excess debt by one percentage point of their GDP throughout their national spending plan. The requirement is halved for those in the 60% to 90% GDP range. These rules are deemed "more lenient" than the previous iteration. However, they maintain the idea of structural reductions, disregarding country-specific contexts. In addition, the reformed text introduces a new deficit safeguard, which adds an additional constraint on member states who are either above the 60% debt-to-GDP ratio, or above the 3% deficit-to-GDP ratio. This could counteract the flexibility of the country-specific fiscal–structural plans. Together with the "no backloading" rule (obligation to perform a linear fiscal adjustment over time) they effectively block member states from taking on more debts and invest upfront into the transition.

Longer timeframes incentivise reforms and investments

The four-year adjustment period can be extended to seven years if member states advance investments and reforms. However, this timeframe is not aligned with longer-term investment cycles required for the transition (beyond ten years) and it remains unclear whether fiscal consolidation married with commitment to reforms and investments will lead to public spending in other critical domains such as social policies.

Enforcement of rules and sanctions

An open question remains whether the new rules will foster shared ownership and compliance by the member states.

In this situation, we recommend four avenues to improve the current state of public finances at the national level:

1. Systemic and swift phase-out of environmentally harmful subsidies (EHS).
2. Reduce public budgets' exposure to fossil fuel price volatility and include climate risks and damages in budgetary planning
3. Improve the resilience of national taxation systems
4. Bring the costs of deteriorating public services, and cost of climate inaction & delay into the public debate while highlighting co-benefits of climate action

We outline each of these recommendations in more detail below.

Opportunities for additional national level funding

1. **Systemic and swift phase-out of environmentally harmful subsidies (EHS).** Budget constraints are forcing member states to fundamentally review public expenditure and ensure consistency with the transition. This could pose a common starting point for both fiscally conservative and progressive actors leading to a systematic and swift phase-out of EHS. Recent studies show that up to two-thirds of the investment needs for the transition could be financed by reallocating existing expenditure away from harmful or superfluous budget lines.[104] As well as freeing resources for productive investments for the transition, phasing out harmful subsidies will create behavioural changes and directly reduce emissions and negative environmental impacts. Phasing out fossil fuel subsidies including avoiding locking in fossil infrastructure is also among priority demands of the European Scientific Advisory Board for Climate Change.[105]

[104] Institute Rousseau, Road to Net Zero, **https://institut-rousseau.fr/road-2-net-zero-en/** (webpage, accessed 11 March 2024)

[105] European Scientific Advisory Board, January 2024, **Towards EU climate neutrality – Progress, policy gaps and opportunities**

The social and distributional impacts of such shifts, considering exposure to lower-income households and consumption-related activities, will have to be measured and addressed by providing sustainable fossil-free alternatives. Research shows that there is much room for improvement, as some of the public support during the 2022 energy crisis for instance did not primarily benefit vulnerable groups and had regressive distributional impacts.[106]

2. **Reduce public budgets' exposure to fossil fuel price volatility and include climate risks and damages in budgetary planning.** The past two years of fossil fuel price volatility have put exceptional pressure on public budgets. This volatility is likely to persist or increase through the transition period, while the EU steadily weans itself off fossil fuels. Incorporating this into the assessment of and decision making on public finance and debt sustainability will allow better decision making overall. Such planning could also increase credit rating agencies' confidence in public finances. For example, the UK Office for Budget Responsibility recently estimated that recurring fossil fuel price volatility is likely to add more than double the public debt burden in a scenario where fossil fuel dependence is not reduced than in one where investments in net zero are made promptly.[107] Assessing the possible impact of fossil fuel price volatility should become a regular feature of the European Semester (see Box 2) and fiscal stability reports. Another mounting risk to fiscal stability is the increasing exposure to climate-related disasters. In 2022, the drought and the storm Eunice were among the top 10 most expensive climate events worldwide, with combined damages of more than €25 billion.[108] Budgetary considerations urgently need to include the costs of inaction and climate risks. As long as those are not properly considered, we will only continue to see ex-post emergency expenditure in budgets that is a multiple of potential ex-ante investments into adaptation and resilience to reduce disaster-related impacts. In the 2024 European climate risk assessment, the European Environment Agency (EEA) reported that by 2050 annual climate change impacts would exceed 2.5% GDP in most European countries (COACCH project). This would create significant impacts on the tax base via reduced productivity as well as increased public expenditure.[109]

3. **Aligning national taxation systems with sustainable goals and standards.** A recent study by Oxfam and the Stockholm Institute suggests that **progressive taxation** can respond to the twin crisis of climate change and economic

[106] Institute for European Environmental Policy, May 2023, **Who took the burden of the energy crisis?**

[107] E3G, July 2023, **A new gold standard in the fiscal analysis of the energy transition**

[108] Christian Aid, December 2022, **Counting the Cost 2022: A year of climate breakdown**

[109] European Environment Agency, March 2024, **European Climate Risk Assessment Unedited**, p. 245

inequality.[110] Due to their consumption, the top 10% of the EU population is responsible for 28% of carbon dioxide emissions (Figure 8). According to UNCTAD, inheritance is the strongest driver of growing wealth inequality, and therefore inheritance taxation would be a promising counter measure.[111] Additionally, consumption taxation on carbon-intensive, luxury products and services could send a price signal while providing additional revenue to governments. In this context it is important to emphasise that a sole focus on environmental taxation is not enough to tackle the double crisis to ensure that the transition is socially just. The multiple crises the EU is facing call for integrated solutions. There is a growing body of literature highlighting the link between growing economic inequality and eroding trust and support for liberal democracies. [112] Tackling both challenges at the same time would be a way forward as concrete proposals are brought forward regularly.[113] One concrete suggestion to create coherence within the EU in this context would be to **vary corporate tax rates based on taxonomy-alignment.** The Taxonomy Regulation applies to both the market and member states. If member states were to decide at the national level that their tax policy should encourage sustainability, for example by lowering tax rates for companies engaging in "sustainable" activities, the obvious point of reference would be the Taxonomy Regulation. While the legal basis of the Taxonomy Regulation does not include taxation, the increasing use of the taxonomy could increase pressure on member states to start using tax policy as a tool for greening the economy. Critically, to bring value the EU taxonomy criteria must be science-based, as required by the regulation.

More generally speaking, now is the time for governments to make plans to maximise and fine tune taxes linked to fossil fuel consumption to set efficient incentives for a fast switch away from fossil fuels (which could reduce the need for clean energy subsidies), while implementing strategies to grow alternative revenue sources.

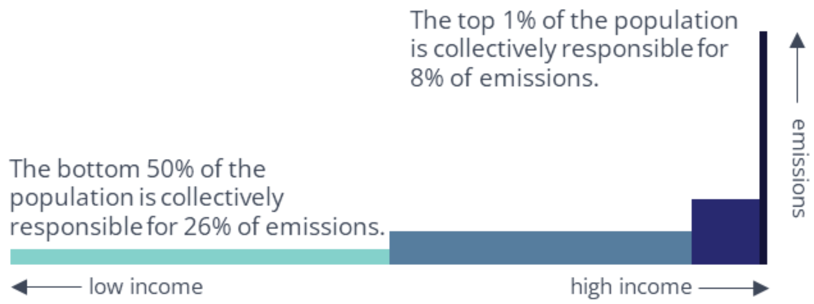
[110] Oxfam, November 2023, **Climate Equality: A planet for the 99%**

[111] UNCTAD, April 2023, **Working Paper 4/2023, Wealth Distribution, Income Inequality and Financial Inclusion: A panel data analysis (PDF)**

[112] Project Syndicate, August 2023, **Inequality and Democracy**

[113] See for example: Eurodad, February 2024, **Make polluters pay – how to tax excessive ecological footprints** (PDF)

CO_2 emissions inequality in the EU



2019 data

Source: Stockholm Environment Institute, Emissions inequality calculator

Figure 8: the TOP 10% higher income in the EU are responsible for a disproportionate amount of CO_2 emissions.

4. **Raising the awareness: deteriorating public services and the cost of climate inaction**. Since 2023, right-wing parties in Europe have successfully campaigned on a call for fiscal consolidation using a narrative of taking back control, for example in the parliamentary elections in Finland and polls in Germany.[114] Progressive political parties would be well advised to raise awareness of the societal, economic, and environmental costs of climate inaction, thereby challenging the support for fiscal consolidation and laying the ground for a positive vision of the transition (see Introduction above) to build popular and political support.[115]

Building sizeable and predictable EU funding

State of play

EU MFF 2021–2027 under pressure. Negotiations on the mid-term revision of the MFF concluded on 6 February 2024. The original European Commission proposal[116] suggested a top-up of the MFF with additional contributions, acknowledging that the several crises (such as the war in Ukraine) have strained the long-term budget. However, member states were very resistant, and requested redeployment of funding from existing budget lines as an alternative. The negotiation around the Strategic Technologies for Europe Platform (STEP) is a case in point: from the originally proposed €10bn, eventually lawmakers

[114] Fiscal consolidation was a major political demand in the Finnish parliamentary elections 2023.

[115] CAN-E, January 2024, **Paris Pact Payoff – Speeding up the green transition for socio-economic co-benefits** (PDF)

[116] European Commission, June 2023, **Commission proposes to reinforce long-term EU budget to face most urgent challenges**

agreed on a €1.5bn additional top-up exclusively contributing to the development of Europe's arms industry (European Defence Fund). In fact, due to the combined effect of high inflation and unforeseen emergency expenditures, most budget lines of the MFF were subject to cuts in real terms.

Low absorption of existing funds. Some governments are also hesitant to provide more funding at the EU level as existing resources are not fully used yet. This low absorption is explained by a capacity crunch at the level of implementing entities at national and subnational level. The reason for the crunch is the simultaneous programming of the RRF and the funds under the MFF 2021–2027. The looming disbursement deadline of the RRF has led implementing authorities to prioritise using this money. However, both funds will come to an end around the same time (2026–27).

These temporary difficulties should not serve as a pretext to reduce EU budget funding overall, as after 2025 we expect a strong decline in public funding within the EU.[117] Rather, governments should increase absorption and deployment capacity by strengthening administrative capacity to process funding requests. In addition, more funding could be put towards managing the funding ("technical assistance").

Mixed outcomes on the governance of European funds. Beyond the quantitative question, improving the quality and effectiveness of the governance of EU funds is critical. The EU has driven some innovations to improve the quality of its spending over the previous MFF funding period (2013–2020). Among those are the do no significant harm principle (DNSH), climate and environmental mainstreaming, sectorial targeting, and some requirements for additionality of EU funding. However, several institutions have criticised the methodologies to evaluate the conditions, such as the 20% earmarking of funding for green investments in the previous MFF funding period, claiming that the reported numbers are overstated.[118] Overall, we need stricter compliance with the DNSH principle, for example through a ban on fossil fuel investments, while ensuring strong earmarking, as well as closer conditionality based on the EU taxonomy criteria. More detailed elaborations below.

[117] Bruegel, September 2023, **New Governance Framework to safeguard the European Green Deal**

[118] European Court of Auditors, 2022, **Special Report 09/2022C: Climate Spending in the 2014-2020 EU budget** (PDF)

Opportunities for additional EU-level funding

Beyond member states increasing their direct financial contributions to the EU, we propose two principal ways by which the demand for additional EU-level public funding could be leveraged.

1. Leverage EU-level funding through the issuance of common debt

The RRF (see Box 4) is a temporary debt-based investment facility set up to financially support the economic rebound after the COVID-19 pandemic.[119] It is financed through the issuance of Eurobonds and makes grants and loans available to member states for future-oriented investments. For member states with limited fiscal space, it became a crucial source for climate investments, showing that issuing debt can be a successful way to boost investments.[120] It is also an excellent example of linking funding to conditionality on reforms. The National Recovery and Resilience Plans (NRRPs) as the base for investments provide a strong lever to ensure that the funding brings value added with a long-term perspective. This is spearheaded through the definition of milestones and conditional disbursement based on achieving previously agreed milestones.[121]

Although this level of conditionality has effectively encouraged compliance with reforms in certain countries, it has sometimes prevented vital investments from progressing when reforms are stalled due to reasons unrelated to the investment project. In future designs, it is crucial that conditionality is directly tied to reforms that are better linked to the funded project to prevent large delays in the investment due to reasons unrelated to the transition.[122] A permanent investment fund in the style of the RRF would provide a prolonged and predictable avenue to address potential funding gaps in critical areas like climate, security, and social policy, thereby complementing existing member state resources.

In early 2023, the European Commission **proposed an EU Sovereignty Fund** as a long-term facility to provide and channel investment-oriented resources. In the end, however, the Commission replaced the idea with the much smaller, and severely underfunded, STEP, as it became evident that EU member states have no appetite to transfer additional funds to the European level. Nor is establishing a new debt-based instrument currently politically palatable as governments

[119] European Commission, **The Recovery and Resilience Facility**

[120] Agora Energiewende, June 2023, **EU Climate Funding Tracker**

[121] Centre for Economic Reform, November 2021, **Why the EU's recovery fund should be made permanent** (PDF)

[122] Paola Tamma, Financial Times, 20 February 2024, **Is the EU's Covid Recovery fund failing?**

favour the reallocation of existing unused funds.[123] However, while investment needs become more and more evident and nuanced at sectoral levels, there is rising awareness that additional funds for investments will be needed in the coming years.[124] As a consequence, the EU Sovereignty Fund and other proposals, such as a European Climate Investment Facility, continue to gain attention among EU policymakers and may regain political momentum.[125]

2. Introduce additional own resources at EU level based on just transition aspects.

In light of member states' resistance to providing additional financial contributions to the EU level, debates on levies that contribute to the EU budget have reemerged with the intention of widening and diversifying the EU's revenue base. The call for the creation of additional revenue flows for the EU is not new. The adoption of the Next Generation EU Recovery Plan and the MFF 2021–2027 already brought attention to the importance of EU proprietary resources that are independent of the financial contributions from member states.

To put EU resources on a stronger footing, the European Commission announced additional so-called "own resources": levies that apply across the EU, the proceeds of which flow to the EU budget.[126] So far, two additional own resources have been implemented. The first is the plastics own resource ("plastics tax"), a contribution based on non-recycled plastic packaging, introduced in 2021.[127] The second is the Carbon Border Adjustment Mechanism (CBAM).

In June 2023, the European Commission published an adjusted package for reformed own resources, which included an increased share of ETS revenues to be channelled to the EU-level (Box 3) and a technical adjustment of the CBAM.[128] Later in 2023, the Commission put forward the "BEFIT" policy package, recommending an EU approach to corporate taxation.[129] This initiative would build on a process under the OECD/G20 international tax agreement on a global

[123] Euractiv, March 2023, **EU's Breton: Joint Debt for green transition no longer a priority**

[124] Institute for Climate Economics, March 2024, **European Climate Investment Deficit Report**

[125] European Policy Centre, February 2024, **A two-tier federal budget for the European Union**

[126] European Parliament Research Service, June 2023, **Reform of the EU System of own resources: State of play**

[127] European Commission, **Plastics own resource** (webpage, accessed 11 March 2024)

[128] European Commission, June 2023, **An adjusted package for next generation of own resources** (PDF)

[129] European Commission, September 2023, **Taxation: New proposals to simplify tax rules and reduce compliance costs for cross-border businesses**.

minimum level of corporate taxation.[130] It is however unclear if and when this multilateral process will be adopted.

In a critical resolution in May 2023, the European Parliament called for a consideration of a potential corporate taxation scheme, a financial transaction tax and a tax on cryptocurrency among others.[131]

As of March 2024, member states have not agreed on a position concerning the proposal for the EU's own resources. Climate Action Network Europe (CAN-E) have estimated the potential of various new additional own resources.[132] The potential revenue from the proposals ranges from €350 million for an EU-wide private jet flight tax, through €5 billion for a digital tax, a fossil fuel windfall tax of €7.5 billion, up to an EU-based financial transaction tax potentially leveraging up to €300 billion. The economic policy think tank Bruegel have complemented the debate with a recommendation, inspired by the CBAM, to use EU-level external border taxation schemes on personal income, wealth, or heritage (common EU exit tax) to avoid tax leakage and boost EU own resources.[133]

For those policy proposals the upcoming negotiations on the next EU Multiannual Financial Framework are a key opening to bring EU own resources on stronger footing and the investment gap can be a powerful lever to increase the political pressure for substantial reform.

Box 3

Use of the growing proceeds from the EU Emissions Trading System

The European Emissions Trading System (EU ETS) generates financial resources through the auctioning of emission allowances. It is regarded as one of the most mature and stable carbon market instruments internationally, and underwent a revision concluding in 2022. Since it generates funds at the European level, it is a crucial reference when

[130] OECD, November 2023, **OECD/G20 Inclusive Framework releases new multilateral convention to address tax challenges of globalisation and digitalisation.**

[131] European Parliament, May 2023, **Own resources: A new start for EU finances, a new start for Europe**

[132] Climate Action Network Europe, September 2023, **New resources for public climate finance and for the Loss and Damage Fund** (PDF)

[133] Pascal Saint-Amans, March 2024, **Broader border taxes: a new option for European Union Budget resources** (PDF)

discussing EU own resources, but it also plays a role in the decarbonisation of European industries.[134]

While most of those proceeds flow to member states, a share of the proceeds equips the two EU-level Modernisation and Innovation Funds (see Box 4, below). Moreover, from 2024 onwards, 100% of the ETS proceeds need to be spent on climate and energy objectives. In 2022, the ETS generated €6.8 billion for Germany and €5 billion for Poland. Those two states together with Italy and Spain received 60% of overall ETS proceeds.[135]

The funds generated from the ETS will rise in the future as the price per emission allowance increases due to successive reduction of the total amount of available allowances (the "cap" representing the absolute level of emissions). In the Impact Assessment for the 2040 EU Climate Target, the European Commission calculated that the carbon pricing instruments could amount to €1.5 trillion between 2031 and 2050, which could cover roughly 11% of the total energy system investments needs for the same period.[136] The actual sum of funds generated however depends on the evolution of both the carbon price and emission abatement costs that would reduce the demand for emission allowances. Therefore, the Commission needs to ensure that, despite market dynamics, the price continues to represent a robust incentive mechanism to emissions abatement.

How to win the politics of more EU-level funding: A European industrial strategy

For reasons elaborated above, the creation of another debt-based financing instrument and raising additional own resources for the EU level are difficult demands in the current political environment.

To address these challenges, our approach advocates careful navigation and strategic exploitation of emerging political openings. The imperative for investment extends beyond climate considerations, encompassing vital aspects of European society such as industrial development, economic resilience, social welfare, and security. Hence, our recommendation is to align these concerns and amplify the call for EU-level funding within a unified political narrative. At the

[134] E3G, October 2023, **Industrial transformation for all Europeans** (PDF)
[135] EEA, December 2023, **Use of auctioning revenues generated under the EU Emissions Trading System**
[136] European Commission, February 2024, **Impact Assessment "EU 2040 Climate Target"**

core of this strategy lies the concept of a European industrial strategy, poised to mobilise political support behind a forthcoming "Investment Commission".

Central to this strategy is the notion of "open strategic autonomy", leveraging Europe's inherent strengths vis-a-vis competitors and fostering sustainable growth. This entails judiciously crafting EU public investments alongside bolstering institutional capacity for industrial policy coordination, enhancing resources for sustainability-driven innovation, and prioritising clean energy to enhance industrial competitiveness. More importantly, Europe's investment strategy will have to be rooted in a clearer vision of what the future of EU economy and industry would look like in the broader geopolitical and world economy context.

In essence, an investment plan, fortified by robust environmental and social safeguards and sustained with political momentum, is crucial for guiding Europe towards a net zero future. As we navigate the political landscape in the years to come, strategic alignment will be essential in realising the vision for a successful transition. Furthermore, the timing of this advocacy is opportune, coinciding with the launch of negotiations for the next MFF by the incoming European Commission. It is therefore important to synchronise demands across sectors and advocate diligently for the importance and benefits of EU-level investment funds.

Greening the European Central Bank's monetary policy

As seen in the first section of this chapter, the transition to sustainability requires a significant increase in investment. However, the context of tightening monetary policy by the European Central Bank (ECB) poses a threat to the fiscal space required for these investments since high interest rates make investments more expensive. Coupled with constraints on public debt imposed by the new EU fiscal rules (see Box 2, above), this reduces the capacity of governments to invest in the transition to sustainability.[137]

In general terms, the transition to sustainability presents an additional potential risk of inflationary pressure in the coming decade. Monetary institutions should look for functional ways of addressing high interest rates and increased capital

[137] Green Central Banking, January 2024, **The ECB is wrong. Green dual interest rates are possible – and necessary**

costs, especially for energy transition investments, and enable green and transitioning businesses to continue their operations towards climate neutrality and environmental sustainability.

With such clear principles and guidelines, central banks should consider developing **preferential tools for green or transitional borrowers in specific sectors**. Current discussions about interest rates primarily revolve around the potential for the ECB to implement monetary policies aimed at combating inflation while promoting the viability of sustainable investments. The emphasis is on reducing financing costs for selected sustainable technologies, with a pragmatic exploration of this approach within the banking sector. This includes considerations for refinancing operations and utilising favourable interest rates to incentivise banks to channel funds into green projects. Such considerations were put on the table at COP28 by President Macron in December 2023, with France becoming a potential key player in the debate and with the ECB executive board members Isabel Schnabel and Frank Elderson speaking in favour.[138,139] It is therefore worth mentioning the growing momentum also at the political level. Dual rates would be essential to address the net zero transition investment gap. Lowering interest rates would indeed decrease initial expenses and enhance the competitiveness of renewable energy sources (and in general of all investments which need a high initial cost), leading to increased investment. Additionally, maintaining low interest rates over the medium to long term would diminish uncertainty, providing further encouragement for investments in these sectors.

Moreover, it is also crucial to acknowledge certain technical challenges related to tools like the EU taxonomy and associated policy instruments. These challenges revolve around the difficulties in establishing universally agreed-upon criteria for defining green and transitional activities, entities, and projects. EU and member states therefore have the crucial role to clearly identify green and unsustainable standards (see specific recommendations in Chapter 1, Objectives 1, 2 and 5), with the explicit expectation that central banks will be governed by such standards and not invest in unsustainable assets or support them in any other way. Only in this manner can the framework for a dual interest rate work. This gives further importance to the current work internationally and in the EU on reporting and implementing frameworks for more clarity (see Chapter 1 above, Objectives 1, 2 and 5) and a clear call for the EU to further clarify this in view of upcoming strategic green and transition investments.

[138]Green Central Banking, January 2024, **Macron urged to push for dual interest rates at EU level**

[139] Green Central Banking, January 2024, **ECB could consider dual interest rates, Schnabel says**

Another complementary ECB tool that could be critical is the collateral framework: the guarantees that commercial banks must pledge when borrowing from central banks for the case of default. The ECB is reviewing its collateral framework in the course of 2024. Assets related to high carbon emissions (such as coal plants, or new fossil fuel extraction facilities) and other environmentally harmful assets run a risk of losing up to 100% of their value in light of the phasing out of fossil fuels (stranded assets – see Chapter 1, Objective 5 above). There is a case to integrate this risk in the collateral framework of the ECB in two possible ways:

> By excluding those assets with a highly negative climate or environmental impact.

> By applying higher haircuts to environmentally harmful assets, thus reducing the book value of the guarantee. Haircuts should be set through a sliding-scale approach, in which the sectoral haircut grows (or decreases) depending on the environmental impact of the asset.

Deploying public finance: Strengthening public institutions, levers and tools

It is not enough to have public funding available for investments into the transition. The funding also needs to be effectively deployed not only to leverage private finance, but also to proactively create market demand for activities and solutions that support the transition while providing strong signals to financial market players. In this section, we consider how the EU's public institutions, policy levers and tools can be strengthened to achieve this, with a focus on Europe's development and public banks, green public procurement, and the application of private finance regulatory tools to public funding. Box 4 provides an overview of the main EU funds for deploying climate investments.

Box 4

Main EU instruments for deploying climate investments

During the outgoing European Commission's mandate (2019–2024), the following European Funds have proven key for boosting investments for the climate transition. However, the leveraging of overall private investments, directly coming from such funds, could still be increased.

Recovery and Resilience Facility (RRF)

The RRF was crucial to providing immediate relief and sending a signal of EU-wide solidarity when the COVID-19 pandemic hit European economies, to avoid increasing divergences among member states due to the crisis. The RRF has been funded by the issuance of common debt by the European Commission, which has been a game changer in the European investment landscape. A total of approximately €720bn (2022 prices) in grants and loans is available under the fund, to be used before the end of 2026.

The RRF is based on performance disbursement, therefore making the funding conditional on attaining pre-defined milestones and targets. This introduces an interesting lever to ensure compliance (which is also linked to a country's structural reforms) and is also interesting in terms of its governance: RRF is mainly managed by EU member states (that is, not at regional or local level).

One study has found that RRF has been a key source for climate investments, especially in member states with limited fiscal space.[140] The requirement to spend 37% of the fund on green investments was an attempt to ensure future-proof and high-quality investments. However, ex-post analysis has shown that official numbers are overstated due to an inadequate methodology.[141] Moreover – even if the do no significant harm (DNSH) principle for RRF helped massively to "clean" union funds with RRF being the first one to develop some official guidelines – DNSH guidelines also allow, for example, gas projects under specific circumstances.

To **increase the leverage and deployment of the RRF**, it is firstly important to consider the nature of this fund, which is centrally managed by the member states' capitals. Therefore, it becomes relevant for centrally planned projects and investment. It is important to note the RRF also has regional projects managed by member states. Overall, challenges include perceived rigidity, administrative burden, and limited stakeholder involvement.[142]

To channel finance in the right direction, and genuinely avoid harmful projects, **further technical development of the DNSH guidance is needed**.

[140] Agora Energiewende, June 2023, **EU Climate Funding Tracker**

[141] Green Recovery Tracker, December 2021, **EU recovery: How green is recovery spending in different sectors?** (PDF)

[142] European Commission, February 2024, **Mid-term evaluation of the Recover and Resilience Facility (RRF)**

More detail (for example, sector specific) would be helpful for the disbursement of other funds as well. Indeed, creating common EU tools for enhanced DNSH application across funding instruments could help to **streamline implementation and reduce administrative complexity**, as well as amplifying DNSH contributions to EU climate and environmental objectives. According to a recent analysis, these tools should include a **unified methodology, shared exclusion list, and technical guidance for sectors' transition**.[143]

An analysis of co-financing obligations, as well as further optimisation of grants and loan allocations, could be helpful for upcoming disbursements and the potential continuation of this programme after 2026. Mainstreaming partnerships with public banks and private investors could also be another way forward. One example where sources of investments were distributed across public finance, banks and investors is the RRF Loans in Greece. Its financial scheme requires a maximum of 50% to come from RRF Loans, a minimum of 30% from a co-financing loan from a financial institution, and a minimum of 20% from investors' own funds.[144] It is important to note that such financial architecture could have a negative impact on SMEs' access to funds, as they usually have lower credit ratings (which are checked by banks and investors) compared to big corporations.

To conclude, a more tailored approach at member state level could support administrative capacity further in capitals. Ampong other things, and according to the mid-term evaluation of the RRF, the establishment of an informal expert group for cross-cutting discussions with member states could be a way for exploring tools to mitigate the administrative burden for RRF and beyond.

European Regional Development Fund (ERDF) and European Cohesion Fund (CF)

As the biggest fund under the EU cohesion policy 2021–2027, the ERDF is the main fund for financing public infrastructure. Funds under the EU cohesion policy are under shared responsibility, which means that their implementation is managed by the European Commission together with national or regional authorities. This is an important difference in

[143] European Commission, December 2023, **The implementation of the "Do No Significant Harm" principle in selected EU instruments**

[144] Greece 2.0, Recovery and Resilience Facility loans, **https://greece20.gov.gr/en/recovery-and-resilience-facility-loans/** (webpage, accessed 11 March 2024)

governance to how the RRF or the Innovation and Modernisation Funds (see below) are managed. Recent innovations in the way local authorities can better participate in the implementation of the ESIF are the Community-Led-Local-Development initiatives (CLLD) and the integrated territorial investment tool (ITI). The implementation of the ERDF and the Cohesion Fund (CF) is currently lagging as national and subnational authorities prioritised the disbursement of the RRF.

The CF, another fund focusing on infrastructure investment within the EU cohesion policy, is exclusively accessible to certain lower-income countries.[145] **There are several strategic opportunities to enhance the leveraging and deployment of both the ERDF and the CF**. First, the DNSH dimension should be mainstreamed and processes and operational procedures with the RRF such as reporting should be standardised. Better coordination among member states, regions and municipalities to streamline their administrative burden would also improve fund deployment. Secondly, a reassessment of grant and loan-based disbursements is recommended, also in view of regional needs and market structures. Funds should potentially cover the entire cost where risky investments are needed but cannot be covered by the private sector – eliminating the need for co-financing, which can pose substantial impediments. This approach aligns with the consideration, mentioned earlier, of utilising the RRF loan facility for co-financing options when feasible for the risk return ratio of a given market. Moreover, a potential expansion of non-binding targets for guarantee-based funding under these programmes should be pursued to enhance leveraging of the private sector when possible. In this context, exploring synergies, particularly with InvestEU (see below) could offer valuable opportunities for collaboration and efficiency.

Finally, it is of key importance that all of the EU funding programmes are aligned with environmental and just transition objectives. This also means that future funding programmes are excluded from financing (and thereby collectivising) costs caused by polluters. This has happened in the past, as pointed out by the European Court of Auditors.[146] **Therefore the polluter pays principle (PPP) needs to be applied horizontally across the entire EU funding landscape.**

[145] European Commission, **Cohesion Fund**

[146] European Court of Auditors, 2021, **The polluter Pays Principle: Inconsistent application across EU environmental policies and actions** (PDF)

Modernisation and Innovation Funds

While in quantitative terms these funds are much smaller than other EU instruments, they are interesting as they are replenished by proceeds from the ETS and can solely be used for financing climate and (clean) energy projects. While the Modernisation Fund provides financial support to 13 low-income member states, the Innovation Fund is directly managed by the European Commission and directly funds innovative projects, based on regular calls for proposals. The Modernisation and Innovation Funds therefore play a pivotal role in increasing private financing for the transition. However, common challenges exist concerning member state capacity and overall fund absorption.

One challenge among many for the **Modernisation Fund** is administrative capacity at regional and local level. Establishing clear guidelines and potentially offering technical assistance to enhance administrative capabilities can ensure a smoother absorption process. It is further crucial to explore feasible ways to increase the leverage effect for private finance to maximise systemic impact, as the Modernisation Fund can fund projects up to 100%.

Considering the compelling argument for adding more ETS revenues to the fund, a strategy should be devised to increase funding available under the Modernisation Fund. This includes strengthening co-financing obligations, providing incentives for private sector participation, and establishing transparent guidelines for effectively leveraging private finance. Additional funds can also be allocated to guarantee-based instruments when feasible.

The **Innovation Fund** has traditionally focused on “first-of-a-kind” and “breakthrough” investments, where private co-financing needs are relatively low. Funding for these projects should be maintained with additional allocations possible in other areas. As we progress towards 2030, the Innovation Fund could be transformed into a deployment fund, emphasising the deployment of more mature yet expensive technologies. The focus should be on attracting investments and reducing costs for maturing technologies. Moreover, to address investment uncertainties and de-risk projects, a unique solution involves operationalising a newly added possibility: reverse auctioning of carbon contracts for difference (CCFD). Implementing reverse auctioning of CCFD entails companies bidding for grants relative to the carbon price. This innovative approach ensures that companies with lower funding requirements can secure funding, encouraging private sector participation. CCFDs would not only minimise the need for public support to leverage private finance but also provides additional investment certainty – thus lowering capital costs – by stabilising revenues in the face of fluctuating carbon prices.

InvestEU

The InvestEU Fund, launched in 2021 and operational since 2022, aims to support private and public investments in four pre-established policy areas, which represent strategic objectives of the European Commission. These are: sustainable infrastructure; research, innovation and digitisation; SMEs; and social investment and skills. InvestEU is a budget guarantee-based instrument, meaning that entities can have access to EU funding without providing complete guarantees (which would have been required in the absence of the InvestEU programme). As of February 2024, the Investment Committee of the InvestEU Fund has approved €18.9 billion in EU guarantees, unlocking 178 operations, with sixteen active implementing partners ready to mobilise private capital in line with policy areas (by providing direct and intermediated financing solutions for private and public entities which are the "final recipients").

For InvestEU to be further impactful in the upcoming EU private investments, consideration of other policy areas or strategic objectives would be helpful. The Strategic Technologies for Europe Platform (STEP) top-up could be seen as a missed opportunity to be picked up again in this context (with a view to strengthening overall competitiveness in the EU). The expansion of InvestEU provisioning could also serve to cover additional risk in implementing partners' investments (e.g. EIB, EU public banks).

Moreover, EU member states can establish a "member state compartment" within the InvestEU Fund, focusing on specific national priorities. The InvestEU programme allows member states to voluntarily contribute a portion of their Cohesion Policy Funds or their RRF funds to the member state compartment, thereby increasing the EU guarantee's provisioning (with an expected multiplier from the European Commission of 11.4).[147] This voluntary contribution would allow countries to leverage the EU guarantee's high credit rating, as well as boosting the impact of national and regional investments while simplifying administrative procedures. This could be an interesting option for tapping into member states' potential in tailored investments, with further involvement from the EIB and national promotional banks.

[147] European Union, **InvestEU – The Member State compartment** (webpage, accessed 11 March 2024)

EU public banks play a crucial role providing direct and intermediated green and transition finance

Europe's extensive network of public banks has the capacity to coordinate the deployment of transition finance in the EU. Relevant players in this context are ministries (in particular of finance) in EU member states, which can also play a role in increasing internal expertise of EU public banks, as well as contributing to proactive and collective deployment.

Therefore, institutional reform of the European Investment Bank (EIB) – the multilateral development bank (MDB) with a central role in Europe's transition to sustainability – should consider how it can shape the actions of member states' public banks, including those at regional and local level. EU public banks, when planning their next steps, should also consider their ability to offer support in preparing for the deep decarbonisation process that needs to occur after 2030 (see Box 5 below). Direct and intermediated finance is provided not only to the public sector and big corporations, but also to non-listed companies and SMEs, which emphasises the strategic role of public banks.

National finance ministries, shareholders and bank management should strengthen the following key roles of public development banks:

- **Providing thought leadership**, acting as "knowledge banks" being first movers in relevant sectors (such as shipping, hydrogen, and agriculture), enabling rapid learning and replication across different countries and entities, while helping to shape domestic policy frameworks and providing the required patient capital which will enable the development of new climate-friendly industries.
- Ensuring a **line of credit to companies in transition** (from SMEs to big corporations, with direct and intermediated finance) to support entities struggling to access to funds via the capital markets (and the related debt-financing approaches such as the EU Green Bond Standard, etc.).
- Bringing **technical assistance** to the private sector on the two elements above.

Aligning the EIB with Europe's future climate targets and deep decarbonisation

The EIB works with several public development banks (PBDs), including the European Bank for Reconstruction and Development (EBRD – see Box 6) and several based in EU member states, to support the transition across various sectors in the EU (including energy, transport, industry, and agriculture).

Box 5

A vision for the EIB after 2030: driving the EU's deep decarbonisation process.

The EIB's mission is inherently linked to its identity as the EU's financing arm. It is mandated to fund projects in alignment with the EU's strategic priorities.

The EIB is made up of four statutory bodies. The Board of Governors, responsible for high-level decision making, comprises ministers from each of the 27 EU member states – typically finance ministers. Finance ministries are therefore key to developing stronger climate leadership from the EIB.

A thorough review of the EIB Climate Bank Roadmap 2021–2025 is being undertaken to establish priorities for the 2026–2030 period. This exercise will be central in setting strategic orientations for the EIB's role in unlocking the investments necessary for the deep decarbonisation process the EU will be undertaking. This vision will have repercussions that extend beyond the EIB, setting the tone and pace for EU member states' public banks to take on greater ambition and reflect this in a tailored approach to their financing across the various regions of the EU.

Box 6

The European Bank for Reconstruction and Development

The European Bank for Reconstruction and Development (EBRD) is a multilateral development bank originally dedicated to supporting the transition to market-oriented economies in central and eastern Europe. It is now active in over 35 countries, committed to applying the principles of multi-party democracy. It has over time developed a strong private sector focus, primarily investing in regional SMEs and private financial institutions.

EBRD governance is structured around its Board of Governors, which represents all 72 shareholders and retains overall authority over the Bank, thus determining its strategic direction. The Board of Governors however delegates most powers to the Board of Directors, which is responsible for approving the EBRD's country, sector and thematic strategies, as well as policies and operations. Staff from ministries of finance play a crucial role.

The **EU and EIB are both EBRD shareholders** in addition to the EU member states, which demonstrates how closely related both MDBs are in practice. Although EU member states have majority shares in the EBRD, it is not an EU bank.

Although the revision of the EIB's mandate is not imminent, it is important to start considering what the priorities might be. Future revisions of the EIB mandate should consider the strategic positioning and tools of the bank with regards to the deep decarbonisation processes that need to be enacted beyond 2030 to move the EU towards its ambitious 2040 targets and 2050 net zero goal, including its role in the development of the markets of the future through the strategic financing of cutting-edge projects. The bank should aim to go beyond the do no significant harm (DNHS) principle adopted and aim to "do good beyond no harm". While the DNSH is a useful tool to avoid negative spillover effects when investing in a project, this is not sufficient in light of the current climate ecosystem degradation trends. The EIB should ensure all the projects it finances have positive impacts on climate and environmental objectives.

The next challenge for the EIB **will be to align its operations with the ambitious 2040 targets** in pragmatic ways. Public development banks have the role of acting as first movers in sectors needing new technologies, as well as intervening counter-cyclically to shape new green and low-carbon markets. The EIB – alongside other European public banks – will have to move beyond sectors where it currently focuses the majority of its climate action financing, to pioneer new approaches in sectors including hard-to-abate heavy industries and agriculture, developing new investment strategies and financial instruments to make projects bankable with teams comprising financial engineers and biologists, so as to contribute to the deep decarbonisation challenges the EU must face.

A revision of the EIB's mandate should address the following elements, which also apply more broadly to EU public banks. Ministries of finance of EU member states, as shareholders, should work with the banks to implement the following recommendations:

1. **Solve the underutilisation issue of EU public banks generally and EIB specifically**, where the EIB can play an enhanced strategic and coordinating role in bringing national banks together and fostering collaboration and knowledge exchange for supporting the transition both at EU and national and sectoral level.

2. **Plan how the EIB, and EU public banks, can move beyond mere alignment with existing EU legislation and EU member state plans where necessary** to raise the ambition necessary to address the EU's deep decarbonisation challenge.
3. **Increase proactiveness from the EIB, EBRD, and EU member states' public banks in establishing enhanced technical assistance capacity** and ability to develop cutting edge financial products. Revising their mandate would help with these processes.

These recommendations are outlined in more detail below.

Recommendation 1: Solve the underutilisation issue of EU public banks generally and EIB specifically

> **EIB should do more to scale up deep green finance commitments**, being less conservative when it comes to lending and taking riskier investments, thus moving away from "low hanging fruit" by focusing on the additionality its financing provides. The EIB and its shareholders should work on reforms to increase the EIB's lending headroom and the development of innovative financial instruments to achieve this (see Box 7, below). The EIB should further make full use of the technical expertise it has developed and promote knowledge sharing with and between European public banks.

> **EIB should strengthen its approach on transition planning**. EIB can further leverage itself and the EU countries while co-developing countries' strategies together with member state public banks (e.g. via Team Europe).

> **EIB and EU public banks should proactively develop transition plans at country, sectoral, regional level.** This involves designing ad-hoc regional and sectoral transition scenarios at member state level, to be used as benchmarks by regions, cities, sectors, companies, and so on.

Recommendation 2: Plan how the EIB, and EU public banks, can move beyond mere alignment with existing EU legislation and EU member state plans

The EIB should mark a departure from passive alignment with NECPs and NCDs[148] and move towards assuming a proactive and influential role in steering the decarbonisation journey. In this context, it is worth noting that the EIB lacks

[148] National Energy and Climate Plans and Nationally Determined Contributions. For extra-EU operations, EIB could also consider developing a dedicated program for NDC support. Despite the absence of such a support program, the EIB is increasingly providing non-NDC technical advisory services, covering areas such as greening financial systems, adaptation, clean energy, and energy efficiency. While expressing support for the development of more ambitious NDCs and engaging in dialogues with countries in that context, the EIB currently lacks a such a program.

specific strategies to guide its country-level work. Operations within the EU are aligned with the European Green Deal and the mandated national plans submitted by member states to the EU. Proactive deep decarbonisation strategies, independent from EU or international regulation (NDCs and NECPs), should be at the forefront of the transition towards 2030 targets.

Therefore, the EIB should:

> Further explore favourable interest rates (to the degree this is possible) for taxonomy-aligned investments.

> Complete exclusion of fossil fuels financing, also where there are still some few exceptions (gas).

> Strengthen energy efficiency standards and ensuring their operationalisation.

Recommendation 3: Increase proactiveness from the EIB, EBRD, and EU member states' public banks in establishing enhanced technical assistance capacity

To strengthen strategic technical assistance and enhance the provision of cutting-edge financial products, we recommend that ministries of finance of EU member states, as shareholders of these banks, and the banks themselves:

> Revise public banks' mandate to help increase their capacity to develop a more heterogeneous structure of the personnel able to provide tailored and cutting-edge technical assistance not only in ideating the project but also for structuring the financial modelling to give access to funds. For example, including financial modelers, engineers and biologists, who together can come up with pathways, practical projects and financing mechanisms for nature-based solutions and deep decarbonisation projects.

> Enhance and mainstream the use of innovative financial instruments, which is key for EU public banks. Some practical examples are reinforcing guarantee-based instruments under Team Europe, InvestEU, and beyond, as well as innovative blended finance approaches (see Box 4 for more information on EU funds). Guarantee schemes could become the rule in deep decarbonisation projects. At COP28, for example, EIB announced a further €5 billion counter-guarantee scheme for European wind energy manufacturing.[149] The counter guarantees ensure that the risk for commercial banks providing guarantee lines to wind industry developers and

[149] European Investment Bank, December 2023, **EIB commits €5 billion to support Europe's wind manufacturers and approves over €20 billion in financing for new projects**

manufacturers lies with EIB, rather than wind industry actors themselves, thus enabling commercial banks to provide an increased volume of guarantees for the development of wind energy projects in the EU. Another example is reciprocal guarantees between banks and shareholders, as seen in the FCDO–AfDB synthetic securitisation.[150] These were not only guarantees from the bank to other players but even from shareholders to the bank, to free up lending headroom. This liberated capital can be strategically directed towards crucial climate initiatives.

> Improve the engagement with adaptation projects, also by strengthening or developing tailored financial products, which are useful for less marketable projects such as nature-based solutions and biodiversity projects, but also projects in heavy industry and agriculture. In this context, the EU could launch a "resilience mission", which would have governance and advice from across different EU institutions, being hosted by the EIB. To strengthen resilience and adaptation, the establishment of adaptation country platforms for EU member states (where countries are coordinated to develop national adaptation plans and link their investment gaps with pragmatic investment proposals) is relevant. This platform would serve as a robust pipeline for essential tailored projects, providing a clear trajectory for the country's resilience efforts and implementing the EU "resilience mission". Recognising the context-dependent nature of adaptation, such a platform would be instrumental in gaining a granular understanding of specific needs, subsequently facilitating the identification of financial instruments best suited for effective implementation.

> Increase the technical assistance to various stakeholders in their transition processes beyond public and private intermediary lenders to also include regional and local entities, as well as the private sector. This assistance could extend to intermediary lenders, as well as companies collaborating with strategic partners. The aim should be to decrease the overall bureaucracy burden of accessing EU funds, and scaling up regional access to funds and credits.

[150] African Development Bank, United Kingdom and London Market Insurers enter new risk transfer partnership for climate action, 20.10.2022, **African Development Bank, United Kingdom and London Market Insurers enter new risk transfer partnership for climate action | African Development Bank Group (afdb.org)**

Box 7

Financial innovation for the next stage of energy infrastructure transition – three priority areas

The European Green Deal has set a framework for accelerating the EU's energy transition. Energy transition finance needs to adapt to meet the required exponential speed of the transition towards a system that is both increasingly interconnected and reliant on more flexible, digital and decentralised energy solutions. Very often, this requires going beyond traditional public finance support models. For regulated monopolies like network companies setting the right regulatory incentives and decision making structures will be fundamental.

1. **Planning for the downsizing of fossil fuel infrastructure**
   With gas demand set to decline by at least 30% to 2030, the decommissioning of fossil fuel pipelines and how to finance it becomes increasingly important to manage impact on consumers and system operators.
   This requires action from regulators now to manage the risk of stranded assets and facilitate managed divestment strategies. As network usage declines, it may become necessary to create a special purpose fund or support from public banks or other institutions in exchange for decarbonisation commitments, to manage impact on consumer bills.

2. **Mobilising capital for mass electrification**
   The power transmission and distribution sectors need to invest substantially in modernisation and new power lines. Investment has grown steadily over the last five years at ~4% per year. Maintaining this level of growth is the minimum required to reach the estimated €620bn of investment needed to meet European climate objectives in 2030. Most of it will be needed at distribution level, including for less capital intensive and potentially lower return activities like digitalisation.
   Financial regulators and institutions should jointly assess the financing needs of these fast-expanding sectors, including the best ways to facilitate anticipatory investment, the role of counter-guarantees, and capital/gearing requirements.

3. **Enabling smaller scale energy solutions to reach financial markets**
   The energy "acquis" from the European Green Deal facilitates a bottom-up transition. This requires a strong role for locally led transition plans and strategies to mobilise the transformation of transport and heat and

the rollout of decentralised energy solutions. These solutions will only take off if they can be financed, which requires access to financing as well as the right economic incentives. Institutions like EIB and national development banks will play a critical role in providing public sector seed funding and making connections with to private investors. Consistent technical capacity support will be needed in all member states to help municipal and regional authorities develop investable transition plans. Commercial banks will need to increase access to products aligned with EU sustainable finance framework like green loans in all member states.

EU green public procurement

Governments and state-owned enterprises purchase goods, services and works. Collectively referred to as public procurement, this includes everything from buying stationery and sourcing food for the canteen to the materials and labour required building sewage works, bridges and road infrastructure.

The scale of public procurement – 13.3% of EU GDP amounting to €2 trillion in 2017 or over a quarter of total public spending – means it can be used as a strategic tool to reach policy objectives including quality job creation, innovation, or environmental protection.[151]

Strategically **leveraging public procurement to help drive and finance the transition has been an underplayed area to date in the European Green Deal toolbox** – the current public procurement directive has not been modified since 2014. Meanwhile, the US is racing ahead with federal "Buy Clean" initiatives already driving demand and changing the market fundamentals for greener materials, for example in steel, cement, and aluminium.

This is an area in which the EU can best compete – it is unlikely that it will surpass the US and China in raw spending on clean technology sectors. The EU has valuable assets in the form of its single market and regulatory framework, through which it can lead and drive a green, fair and inclusive transition in European and global supply chains.

[151] OECD, n.d., **The OECD Public Procurement Principles** (PDF)

Public procurement could be an especially powerful tool for driving the transition in (heavy) manufacturing industries. Industries such as steel[152] and cement are only at the cusp of their transition, currently making the first large-scale investments to transform and clean up their production processes. These investments are capital-intensive and come with a "green premium"[153] – an additional cost compared to producing the good with conventional, high-carbon methods. **Governments can use public procurement to de-risk these investments** as it will provide investors with certainty that there will be a lead market or demand for their green industrial products. Considering that 25% of steel and 40% of cement is used for public construction,[154] greening procurement can go a long way in driving the transition in these sectors.

In the context of continued fiscal consolidation in the EU, **greening public procurement could be an appealing policy lever as it entails changing the conditions for existing flows of public finance** rather than creating additional ones.

Links for a strengthened public and private finance connection from the EU SF agenda

National and EU-level financing could additionally both leverage private investments and support companies in their transition by aligning those mechanisms with some crucial sustainable finance policies and tools for the private sector, including the taxonomy's do no significant harm (DNSH) principle and the supervision of the transition plans' implementation under the EU due diligence law (CSDDD).

The taxonomy's DNSH: consolidating potential for public finance and transition plans.

In the EU policy context generally, and in the sustainable finance one specifically, the DNSH principle's goal was conceived to prevent adverse effects of EU policies, programmes and investments. This principle – derived from the European Green Deal's "green oath" – has been translated into practical application across various EU initiatives, starting with the EU taxonomy. Here, the DNSH principle's primary goal was ensuring that activities considered as

[152] See for example E3G, February 2024, **Raising ambition on steel decarbonisation: The 2023 E3G Steel Policy Scorecard**

[153] Breakthrough Energy, **The Green Premium** (webpage, accessed March 2024)

[154] SEI, June 2021, **Fostering industry transition through green public procurement: A "how to" guide for the cement and steel sectors**

environmentally sustainable according to the taxonomy would not bring harm to other environmental objectives, while substantially contributing to at least one.

Recent analysis shows that although there are differences in how the DNSH principle is interpreted and implemented in various EU instruments,[155] there are shared elements in how they are applied that can enable the move towards an enhanced implementation of the DNSH principle, maximising the contribution of EU initiatives to climate and environmental objectives, simplifying implementation, increasing consistency across policies and decreasing the bureaucracy burden, while boosting more technical capacity initiatives at EU level. The DNSH principle is already impacting at least six EU instruments and plays a crucial role in integrating environmental objectives into both private and public finance. These instruments[156] include the European Regional Development Fund (ERDF), the Cohesion Fund (CF), the Just Transition Fund (JTF), and the InvestEU Fund (see Box 4 above for details on these) – as well as the previously mentioned RRF, EU Taxonomy Regulation, SFDR and EU Climate Benchmark Regulation (BMR).

In the next five years, there is potential and technical capacity to leverage the knowledge gained from the RRF, taxonomy, and others to develop common tools to coherently harmonise implementation of the DNSH principle across EU instruments, notably for transition investments. The advancements in DNSH considerations within the RRF will enhance the overall framework conditions for investments under the cohesion policy framework.[157] Stakeholders answering the mid-term evaluation consultation of the RRF emphasised the importance of leveraging lessons learned from successful RRF features (pre-financing options, integrated support for both reforms and investments, and so on).

Additional support in EU funding generally and DNSH implementation specifically could also be reflected in sectoral guidance, for example by tailoring technical guidelines for specific high-priority sectors and/or projects, and lowering complexities while enhancing transition finance. Such guidelines may simplify categorisation exercises, provide conditions for compliance, contribute to optimised DNSH assessments processes and support consistency.

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[155] European Commissions, December 2023, **The implementation of the "Do No Significant Harm" principle in selected EU instruments**

[156] ESMA, November 2023, **"Do No Significant Harm" definitions and criteria across the EU Sustainable Finance framework** (PDF)

[157] European Commission, February 2024, **Mid-term evaluation of the Recovery and Resilience Facility (RRF)**

Moreover, principles for the development of transition planning (both at entity and sectoral level) resonating with a consolidated DNSH principle could enhance the development of a public and private finance framework that matches the EU green budgeting provisions.[158] A common exclusion list for EU funds and identifying Environmentally Harmful Subsidies would be helpful steps towards strengthening the application of DNSH.

The DNSH principle is gradually extending into various EU instruments beyond the current 2021–2027 policy cycle. Further mainstreaming DNSH at member state level (and within member states, even at regional and local level) could be a plausible way forward. In the RRF mid-term evaluation, EU and national respondents expressed their satisfaction with DNSH and its usefulness in directing investments towards green and sustainable objectives, noting that the principle could have positive "spillover effects" into national policy systems.

Finally, the EU Platform on Sustainable Finance (EU PSF) has embarked on the task of revising the Taxonomy DNSH criteria, in accordance with the regulation's requirement for regular review. The EU PSF has consistently highlighted the significant usability and understandability challenges associated with DNSH criteria, which have wide-ranging effects from impeding Taxonomy adoption to increasing compliance costs for corporations. Addressing these challenges presents an opportunity to positively impact the commitment to reducing reporting burdens while enhancing the overall ambition of the Taxonomy. It is crucial, therefore, that any improvements in usability do not compromise the ambition level of the criteria. In this context, the establishment of ambitious and user-friendly DNSH criteria could pave the way for a DNSH-aligned reporting category, simplifying the alignment process between DNSH requirements at the private and public levels and facilitating greater funding for DNSH-compliant entities.

A monitoring system for a strengthened public and private partnership: the case of the Corporate Sustainability Due Diligence Directive

The Corporate Sustainability Due Diligence Directive (CSDDD) – the first EU law to mandate large companies from across all sectors to set science-based emission reduction targets, and adopt as well as implement climate transition

[158] The objective of green tracking is to align EU budget endeavours with environmental policy goals. However, there is a crucial need to scrutinise the shift towards achieving no significant environmental harm. Identifying instances of misalignment can contribute to formulating a typology of critical competing policy imperatives, revealing essential trade-offs in public financing. A thorough examination provides valuable insights for designing targeted policy funding pathways, gradually ensuring compliance with the DNSH principle over time.

plans[159] – will require EU national supervisors to oversee the adoption, design and updates of these plans. This enforcement mechanism provides an opportunity to more effectively align public finance with private sector transition efforts and seek synergies between them.

The requirement for companies to adopt and implement climate transition plans, and for supervisors to verify and assess these, could be more effectively linked to the EU public finance instruments.[160] Since the implementation of transition plans is theoretically ensured under the CSDDD (see Chapter 1, Objective 1), companies under the CSDDD will have more opportunities to align their efforts with the European Green Deal objectives, such as DNSH. This can enable more access to EU public finance by those companies that are demonstrating to supervisors their efforts to meet their transition targets. In such a scenario, greenwashing risks can be mitigated by CSRD auditing coupled with CSDDD supervision.

In this way, we can expand the opportunities for companies to access even better means to support the economy-wide transition, and ensure the alignment and synergies between companies' efforts, the objectives of EU public funds and need to bridge the financing gap.

[159] Transitions plans under the CSDDD will describe, among other things, an entity's impact on climate and other sustainability issues. They will however not constitute binding pledges to reach sustainability targets, as meeting such targets can be also influenced by exogenous factors, such as inflation and recessions

[160] Co-financing options, notably within "market-friendly" funds like RRF, InvestEU, etc. could be further untapped. Linkages across these funds and CSDDD alignment can be created, also with the help of national promotional banks. Another element to be further checked is DNSH alignment across e.g. public funding and CSDDD transition plans.

ANNEX: RECOMMENDATIONS ON PRIVATE SECTOR REGULATION

The following tables offer an overview of the recommendations provided on each of the legislative instruments covered in Chapter 1: Private sector finance regulation. The six tables, each corresponding to one of the objectives further described in Chapter 1, are ordered per file and per expected date of revision.

Objective 1: Channelling investments for an effective transition

Date	Legislative instrument	Intervention logic / recommendation	Responsible unit in COM
2024–2029 (continuous review of TSC and new TSC)	**Taxonomy Regulation**	The **Taxonomy Regulation** puts forward criteria to determine whether an economic activity qualifies as environmentally sustainable, in order to establish the degree to which an investment is environmentally sustainable. Recommendations: > Further develop the environmental taxonomy to encompass a broader range of economic activities, including via the adoption of criteria for additional activities prepared by the Platform on Sustainable Finance. > Introduce criteria for activities related to the decommissioning of unsustainable assets. > Tighten climate criteria to ensure alignment with the latest developments of climate legislation.	**FISMA.B.2** (Sustainable finance)

		> Include SMEs within the scope of taxonomy reporting for financial institutions, to incentivise financial institutions to support SMEs to green their business and in turn to push SMEs to report their taxonomy alignment. > Expand the environmental taxonomy to clearly define “intermediate” and environmentally unsustainable activities. Additionally, the initiative of a **social taxonomy** has been part of the EU’s sustainable finance agenda but is yet to be developed. Therefore, this report also recommends to: > Expand the taxonomy framework to define social sustainability. > Harmonise terminology and concepts already included in existing provisions around social sustainability. > Go beyond the taxonomy’s minimum safeguards ensuring climate and environmental efforts do not have unintended harmful impacts on society. > Provide financial institutions with guidance on how to comply.	
2026–2030	**CSDDD**	The **Corporate Sustainability Due Diligence Directive** requires large companies to identify, prevent and minimise environmental harm and human rights violations in their operations, subsidiaries and value chains by conducting sustainability due diligence. It also requires all large financial and non-financial companies in the EU to set up climate change mitigation targets, and adopt and implement transition plans. Recommendations: > Expand the scope of transition plans from climate only to environmental and sustainability issues more broadly in the 2030 general review of the CSDDD. > Clarify three specific issues in the guidelines on transition plans that will be developed by the Commission: • What reference climate scenarios and sectoral pathways companies should use to set their 1.5°C-compatible climate targets and transition plans. • What methodologies firms should use to set science-based targets, on climate change in particular.	**JUST.A.3** (Company law)

		• How companies should develop and implement their transition plans, in full alignment with the ESRS reporting structure on the adoption side, and the CSDDD on the adoption and implementation side, incorporating elements from prudential plans.	
2027–2029	**Green Bonds Regulation**	The **Green Bonds Regulation** lays down uniform requirements for issuers of bonds that wish to use the designation "European Green Bond", thereby creating optional sustainability disclosure requirements for those issued in the Union. Recommendations: > Ensure that 100% of underlying assets (not 80% as of today) are taxonomy-aligned. > Assess how the standard should gradually become mandatory.	**FISMA.B.2** (Sustainable finance)
2027–2030	**CSRD** and **ESRS**	The **Corporate Sustainability Reporting Directive (CSRD)** creates sustainability reporting obligations for all large companies, with the aim to increase the transparency, comparability, credibility and usability of sustainability data. It is being completed via Delegated Acts, in which EU-wide harmonised European Sustainability Reporting Standards (ESRS) are detailed. Recommendations: > Fully implement corporate reporting standards in the CSRD and related ESRS so that companies and financial firms better understand and manage company-level sustainability impacts and risks. > Ensure that auditors providing limited assurance to CSRD reports have the relevant capacity and sustainability expertise to audit both transition and prudential plans.	**FISMA.C.1** (Corporate reporting, audit and credit rating agencies)

Objective 2: Ensuring consistency and effectiveness of sustainability reporting

Date	Legislative instrument	Intervention logic / recommendation	Responsible unit in COM
2024–2029	**Alternative Investment Fund Managers Directive**	The **Alternative Investment Fund Managers Directive (AIFMD)** establishes a harmonised regulatory framework for the management and supervision of alternative investment fund managers operating within the EU. Recommendation: > Revise the AIFMD to better include sustainability considerations, including on remuneration structures.	**FISMA.C.4** (Asset management)
2027–2030	**CSRD** and **ESRS**	The **Corporate Sustainability Reporting Directive (CSRD)** creates sustainability reporting obligations for all large companies, with the aim to increase the transparency, comparability, credibility and usability of sustainability data. It is being completed via Delegated Acts, in which EU-wide harmonised European Sustainability Reporting Standards (ESRS) are detailed. Recommendations: > Adopt reporting standards for eight high priority sectors, including those already under development (oil and gas, mining, road transport, textiles), as soon as possible and well ahead of the 2026 deadline. > Preserve sufficient levels of ambition and granularity in future sets of ESRS, and if possible, improve them. > Require companies to disclose cross-cutting or otherwise mandatory sustainability indicators in other EU laws, with indicators including at least Scope 1, 2 and 3 greenhouse gas emissions as well as indicators required for the reporting of financial institutions, including in SFDR, Pillar 3 disclosures of CRR-CRD and the EU Climate Benchmark Regulation.	**FISMA.C.1** (Corporate reporting, audit and credit rating agencies)

		> Look into the diversification of the sustainability assurance market and ensure appropriate sustainability reporting quality during CSRD future reviews.	
2028–2030	**ESG rating activities**	The **Regulation on the transparency and integrity of ESG rating activities** aims to boost investor confidence in sustainable products by strengthening the reliability and comparability of ESG ratings. Recommendations for the future review of the regulation: > Introduce minimum quality principles or thresholds for ESG rating methodologies, including mandatory integration of double materiality, capturing both risks and impacts. > Ensure group-level separation of ESG rating companies from financial services companies including credit rating agencies. > Include ESG data providers in the scope of the law.	**FISMA.c.1** (Corporate reporting, audit and credit rating agencies)
2028–2030	European Single Access Point (**ESAP**)	The **European Single Access Point** is a package of three laws aiming to provide centralised access to publicly available information of relevance to financial services, capital markets and sustainability. Recommendation: > Assess the functioning of ESAP and consider including key additional information from upcoming sustainability-related financial legislation during its first review.	

Objective 3: Removing obstacles for consumers to invest sustainably

Date	Legislative instrument	Intervention logic / recommendation	Responsible unit in COM
2024–2025	**Mortgage Credit Directive**	The **Mortgage Credit Directive** aims to set up a harmonised mortgage credit market in the EU, with a high level of consumer protection. The report recommends revising the directive in order to: > Provide a single EU definition of green bonds and mortgages, consistent with the EU taxonomy. > Support the update of green mortgages. > Set up measures to scale up financing of the energy renovation of buildings.	**FISMA.B.3** (Retail financial services)
2024–2025 (if legislative process not completed) 2026–2027 (review, if completed)	**MiFID** and **IDD**	The **Markets in Financial Instruments Directive (MiFID)** and the **Insurance Distribution Directive (IDD)** are both part of the Retail Investment Strategy, which aims to ensure that retail investors can make informed decisions that are aligned with their needs and preferences. Recommendations: > Make sustainable funds the default option for retail investors. > Develop a Delegated Act to help financial advisers ask their retail clients about their sustainability preferences, in the form of a template questionnaire. > Provide sustainability training for financial advisers, validated by a certificate. > Introduce an inducement ban.	**FISMA.C.3** (Securities markets) Other units involved include: **FISMA.C.2** (Financial markets infrastructure) **FISMA.C.4** (Insurance and pensions)

2024–2026	**SFDR**	The **Sustainable Finance Disclosure Regulation (SFDR)** is a disclosure-based regulation aimed at creating transparency on how financial market participants disclose sustainability risks and principle adverse impacts at both product and entity levels, although it has been misused as a labelling regime on sustainable funds. For the future review of the SFDR, the report recommends to: > Make sustainability reporting mandatory for all products, not just those with sustainability objectives, and define a specific set of indicators for all funds. > Replace the current Article 8 and 9 framework with a new mandatory product categorisation system with minimum mandatory criteria that define what constitutes an investment product that is sustainable, in line with social or environmental objectives, or contributes to either. > Ensure consistent entity-level reporting alongside product-level disclosures and develop specific disclosure requirements for engagement objectives.	**FISMA.C.4** (Asset management) Other units involved include: **FISMA.A.1** (Policy definition and coordination) **FISMA.B.2** (Sustainable finance)
2024–2026	**UCPD**	The **Directive on Unfair Consumer Practices (UCPD)** aims to boost consumer confidence via better protection against unfair commercial practices and better information. It will be amended by the **Directive on empowering consumers for the green transition**, which includes unfair claims based on offsetting in the list of banned practices, and is expected to be complemented by the **Green Claims Directive**. Recommendation for the review of these files: > Include further strengthened sustainability considerations, such as design features limiting a product's lifespan.	**JUST.B.2** (Consumer law)
2028–2030	**PRIIPs**	The **Package Retail Investment and Insurance-Based Products Regulation (PRIIPs)** aims to update the **key information document**, notably by introducing a section on sustainability information.	**FISMA.B.3** (Retail financial services)

(application by summer 2025)		Recommendation: > Include critical sustainability information already required in other EU laws in the PRIIPs key information document, in the form of five indicators relating to funds: i. taxonomy-alignment ii. coal, oil, gas exposure iii. whether the fund is under SFDR's Article 6-8-9 iv. climate score or degree of Paris-alignment v. principal adverse impacts, if any.	Other units involved include: **FISMA.C.4** (Asset management)
2028–2030	**DMFSD**	**The Distance Marketing of Consumer Financial Services Directive (DMFSD)** aims to protect consumers from increased online sales of financial products, as it requires consumers to be provided with a large set of information before they are bound by a distance contract or offer. Recommendation for the future review of the directive: > Assess how to introduce sustainability information in the directive, building notably on the review of SFDR categories of sustainable funds.	**JUST.E.1** (Consumer policy) Other units involved include: **FISMA.C.1** (Corporate reporting, audit and credit rating agencies)

Objective 4: Setting strong standards for due diligence and engagement by financial institutions

Date	Legislative instrument	Intervention logic / recommendation	Responsible unit in COM
2024–2026	**SRD II**	The **Shareholder Rights Directive II (SRDII)** establishes rules promoting the exercise of shareholder rights at general meetings of companies that have at least one registered office in the EU, with the aim to facilitate the identification of shareholders and transmission of information to them. The report recommends revising the directive and build on the relevant parts of the EU regulatory framework on sustainable finance to: > Define stewardship in a way that clearly links investor engagement activities with sustainability impacts and clarify what responsible engagement entails. > Enhance disclosures to require investors to publish their engagement plans using a standardised and comparable format that monitors and reports on the status of engagements, discloses voting policy, rationale and results, and includes an escalation policy and sectoral expectations on ESG issues. > Set duties for financial institutions, as well as their directors, to conduct engagement practices effectively in the long-term best interest of the financial entity, the investee companies and the stakeholders affected by the latter, considering the impacts, risks, opportunities and leverage – and including a duty to ensure that investee and portfolio companies adopt and implement credible, science-based targets and transition plans. > Develop a more comprehensive framework equipping investors and financiers with (i) wider engagement requirements covering also hedge funds, fixed income and private markets, and (ii) incentives to pursue engagement practices more holistically.	**JUST.A.3** (Company law)

		> Remove obstacles to promote collaborative engagement on a wide set of sustainability matters, including through issuing guidance on the issue to investors and via a review of rules on remuneration policies. > Ensure that supervisors have a mandate to monitor sustainability engagement and enforcement powers over investors.	
2026–2030	**CSDDD**	The **Corporate Sustainability Due Diligence Directive (CSDDD)** requires large companies to identify, prevent and minimise environmental harm and human rights violations in their operations, subsidiaries and values chains by conducting sustainability due diligence. Recommendations for the 2026 and 2030 reviews of the directive: > Fully include the financial sector, including downstream due diligence rules covering their financial activities, in the scope of the CSDDD (2026). > Define adverse environmental impacts in a comprehensive way via impact categories (2030).	**JUST.A.3** (Company law)

Objective 5: Accounting for climate and sustainability risks

Date	Legislative instrument	Intervention logic / recommendation	Responsible unit in COM
2024–2025	**Investment Firms Regulation** (and **Directive**)	The **Investment Firms Directive** requires investment firms to have robust governance arrangements in order to report to management bodies all material risks and risk management policies. As for other legislative instruments relevant to this section, the report recommends reviewing the file to introduce higher capital requirements for fossil fuel-related exposures.	**FISMA.D.1** (Banking regulation and supervision)
2024–2026	**CRR** and **CRD IV**	The **Capital Requirements Directive** lays down uniform rules concerning general prudential requirements that institutions, financial holding companies and mixed financial holding companies should comply with. As for other legislative instruments relevant to this section, the report recommends reviewing the file to introduce higher capital requirements for fossil fuel-related exposures.	**FISMA.D.1** (Banking regulation & supervision)
2024–2026	**IORP II**	The **Directive on the activities and supervision of institutions for occupational retirement provisions** sets common standards to ensure the soundness of occupational pensions. As for other legislative instruments relevant to this section, the report recommends reviewing the file to introduce higher capital requirements for fossil fuel-related exposures.	**FISMA.D.4** (Insurance and pensions)
2025–2029	**Solvency II**	**Solvency II** sets out requirements to all insurance and reinsurance companies established in the EU, with the objective to guarantee the adequate protection of policyholders and beneficiaries. As for other legislative instruments relevant to this section, the report recommends reviewing the file to introduce higher capital requirements for fossil fuel-related exposures.	**FISMA.D.4** (Insurance and pensions)

2025–2029	**Credit Rating Agencies Regulation**	The **Credit Rating Agencies Regulation** sets rules and standards established by governmental or financial regulatory bodies to oversee and regulate the operations of credit rating agencies, to ensure transparency, accuracy and reliability for investors. Recommendations: > Clarify how credit rating agencies integrate sustainability factors in credit rating methodologies, especially via better disclosure requirements on methodologies, stronger monitoring by ESMA, and a requirement to evidence the sustainability competence of staff to the supervisory authorities. > Clarify how credit rating agencies consider the transition plans and prudential plans of rated companies. > Strengthen the "rating outlooks" that apply to all European issuers to better show how a given issuer is exposed to mid- to long-term sustainability risks.	**FISMA.C.1** (Corporate reporting, audit and credit rating agencies)

Objective 6: Enhancing accountability and sustainability expertise in corporate governance practices

Date	Legislative instrument	Intervention logic / recommendation	Responsible unit in COM
2024–2029	Inter-institutional agreement on a mandatory **Transparency Register**	The **Transparency Register** imposes certain rules on interest representatives that lobby EU institutions. The report recommends reviewing the inter-institutional agreement on a mandatory transparency register to: > Ensure greater enforcement of compliance with Transparency Register rules. > Enhance the public disclosure of consultation meetings to include information about who from each side participated in every meeting and what topics were discussed. > Cap the number of meetings that can be held by European institutions with any single stakeholder over a certain time period.	**SG.C.1** (Transparency)
2025–2029	New initiative on pay structure (**EU Director Pay Structure Directive**)	The report recommends developing a **new initiative on EU director pay structure**, which should make management remuneration increasingly dependent on a company's progress in addressing sustainability impacts.	**EMPL.C.1** (Labour law)
2029–2030	**CSDDD**	The **Corporate Sustainability Due Diligence Directive (CSDDD)** requires large companies to identify, prevent and minimise environmental harm and human rights violations in their operations, subsidiaries and value chains by conducting sustainability due diligence.	**JUST.A.3** (Company law)

The report recommends reviewing the directive to:

> - Meaningfully link directors' financial incentives and remuneration to companies' progress on sustainability objectives, including in corporate transition plans.
> - Establish directors' duties for sustainability matters, ensuring oversight, responsibility and accountability at the highest level of the company.
> - Assess how sustainability expertise can be ensured in corporate governance, in particular via gathering best practices across European companies and issuing a public consultation.