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**E. European Impact**

## **Sustainable Finance and its Sustainability**

ESCP Impact Paper No 2021-35-EN

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## **Sustainable Finance and its Sustainability**

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### **Abstract**

We describe how Sustainable Finance is understood in the European context, its current state, and its outlook. We argue that while the framework currently being developed to standardize our understanding of sustainable investments is absolutely necessary, it is also crucial for concrete laws and regulations to be created to incentivize actors in the financial markets to redirect funds from non-sustainable investments to sustainable alternatives.

Keywords: Sustainability, Finance

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## **Sustainable Finance and its Sustainability**

### **Sustainable Finance. What is it and what is it for?**

The European Commission (EC) defines sustainable finance as “the process of taking due account of environmental, social and governance (ESG) considerations when making investment decisions in the financial sector, leading to increased longer-term investments into sustainable economic activities and projects” (EC, 2021).

Broadly, the need for sustainable finance arises from the fact that the public sector is unable to fund the activities and projects necessary to attain societal and political objectives related to sustainability. These goals are captured in the global context, among others, by the UN 2030 agenda and sustainable development goals, and by the Paris climate agreement. In the European context, on 11 December 2019, the European Commission presented the European Green Deal, with the objective of making Europe the first climate neutral continent by 2050.

Sustainable finance is supported by Sustainable Investing, broadly defined as an investment approach that considers environmental, social and governance (ESG) factors in portfolio selection and management. A related term is Socially Responsible Investment (SRI), an asset allocation style in which investors consider “social, environmental, and institutional ethicality aspects” that go beyond the returns and volatility of these investments (Puaschunder, 2016). Financial resources are allocated by conscientious investors based not only on economic performance but also on the societal impacts of the funded entities.

According to the Global Sustainable Investment Alliance (GSIA), sustainable investment grew to more than \$30 trillion in 2018, a 34% increase since 2016, and is set to keep rising as consumer tastes shift and investors demand more transparency. In Europe, ESG investment grew by 11% from 2016 to 2018 and reached €12.3 trillion (GSIA, 2018).

Over the period 2016 to 2018, the proportion of sustainable investment grew in most regions of the world, with the unique exception of Europe (see Figure 1) where the decline must have been due, at least in part, to the expectation of the introduction of stricter standards and definitions for sustainable investing. Even with this decrease in share of sustainable investing, almost half of all managed assets in Europe can be considered sustainable investments.

### **Is sustainable finance, sustainable?**

Clearly, the main challenge over the coming decades is to align investors' different objectives, namely, to maximize returns, reduce volatility and, to the extent possible, take sustainability and corporate social responsibility into account. It is no accident that in our list the objective of sustainability comes last, after maximizing returns and reducing volatility. A priori, these objectives might sometimes conflict with each other. The challenge is then to balance them out through coordination with stakeholders and regulation. In other words, the aim is to foster a global political, legal, and institutional environment that makes sustainable finance sustainable, in the

sense of making it a viable strategy for as many investors as possible. If these objectives are not balanced, we, as a society, run the risk of limiting sustainable investing to a restricted group of conscientious investors.

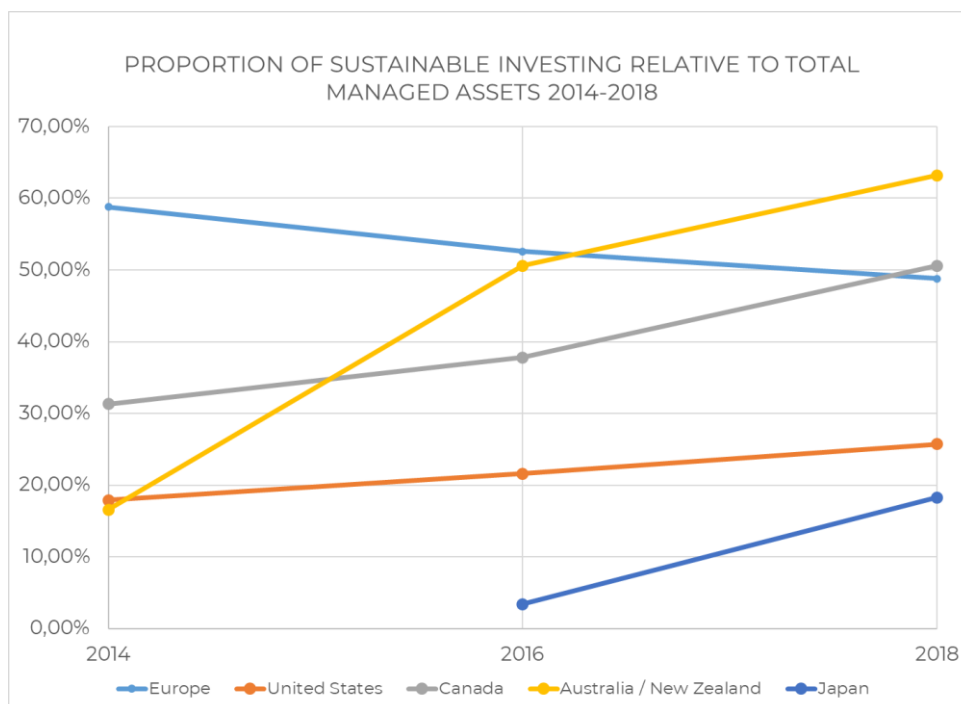


Figure 1: Proportion of sustainable investment relative to total managed assets (2014-2018)

Source: GSIA, 2018

## Paving the way for sustainable investing

To succeed in aligning investors' diverse and sometimes conflicting interests, governmental bodies must act to ensure that, first, there are clear action plans that outline the investments needed to achieve sustainability goals, and second, there are clear ESG criteria for effective screening of funds, portfolios, sectors of activity, and companies.

On the first of these points, the European Green Deal proposed by the European Commission provides an action plan involving a well-defined set of economic sectors, policy areas, and a proposal for a European Climate Law that aims to turn political commitments into legal obligations.

On the second point, in 2020 the European Commission published a Technical Report providing a taxonomy for sustainable investment that provides clear definitions whereby economic activities can be considered environmentally sustainable. The taxonomy sets the following objectives (EC, 2020a):

- Create security for investors.
- Protect private investors from greenwashing.
- Help companies to plan the transition.
- Mitigate market fragmentation.
- Help shift investments where they are most needed.

Tools such as the taxonomy for sustainable investment, green bonds standards and eco-labels are important to guide investors when screening possible investment opportunities. According to the GSIA in its latest sustainability investment report (GSIA, 2018), the most important two strategies used by investors for sustainable investments are:

- *NEGATIVE/EXCLUSIONARY SCREENING*: the exclusion from a fund or portfolio of certain sectors, companies or practices based on specific ESG criteria.
- *ESG INTEGRATION*: the systematic and explicit inclusion by investment managers of environmental, social and governance factors into financial analysis.

From the perspective of companies, a clear Taxonomy Regulation is crucial in clarifying the rules and objectives that grant access to sustainable finance and for improving their environmental performance.

## **Is the European Union doing enough?**

Europe, with a share of 46%, is the region where most sustainable and responsible investing assets are domiciled globally (GSIA, 2018). The region has been a leader in establishing strict standards and definitions for sustainable investments. Still, the question remains as to whether this is enough to achieve the sustainability and environmental goals set by the European Union itself. So far, we have focused on the set of conditions and institutions that have been created to facilitate the job of investors wishing to adopt a sustainable investment strategy, and that of companies and institutions wishing to have access to sustainable funds. The question remains, is this enough to align the different objectives that drive investors? Let us review the European Commission action plan to achieve this goal. In the European Commission's own words (European Commission, 2020b), the action plan involves the following steps:

1. Establishing a clear and detailed EU taxonomy, a classification system for sustainable activities.
2. Creating an EU Green Bond Standard and labels for green financial products.
3. Fostering investment in sustainable projects.
4. Incorporating sustainability in financial advice.
5. Developing sustainability benchmarks.
6. Better integrating sustainability in ratings and market research.
7. Clarifying asset managers' and institutional investors' duties regarding sustainability.
8. Introducing a 'green supporting factor' in the EU prudential rules for banks and insurance companies.
9. Strengthening sustainability disclosure and accounting rulemaking.
10. Fostering sustainable corporate governance and attenuating short-termism in capital markets.

We would argue that, to different degrees, all the steps in the action plan seem advisory in nature. We believe that all these steps are necessary but not necessarily sufficient to achieve Europe's stated goals in terms of sustainability. In order to reconcile the objectives of maximizing returns and fostering sustainable growth, one of two things must occur: either sustainable investments become better than other

alternatives (in terms of increased returns or decreased volatility) or non-sustainable investments become relatively more expensive.

Laws and regulations will play a fundamental role over the next few decades in pushing actors in financial markets towards sustainable investment strategies. This is where the European Climate Law, still in its draft state, will be decisive in saving Europe and the world from environmental catastrophe.

## **Conclusion**

The point we are making is not original, but it is important and must be repeated as many times as possible. Political will is going to play a fundamental role in shifting our economic and financial systems to a new equilibrium. The systems, rules, and institutions that Europe is creating for screening and directing sustainable investment are absolutely necessary but by no means sufficient. Difficult decisions involving real costs must be taken at some point. Coordination, both internal within the region and with the rest of the world, is unavoidable.

We can congratulate ourselves for caring about the problem of sustainability, for trying to understand it and for taking steps to measure our progress correctly. Ultimately though, understanding precisely whether the flood was 1 or 1.1 meters above the previous record is no consolation if we know that we could have built a barrier.

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