



GREENING THE EUROPEAN FINANCIAL SYSTEM

Three ideas for a progressive Sustainable Finance agenda



Summary

The Sustainable Finance agenda is a critical part of the European Green Deal (EGD). It sets public standards for identifying activities that will accelerate the transition to a low-carbon economy (the Taxonomy), standards that can be deployed to steer private finance from brown towards green activities.

The COVID19 global pandemic has rendered the Sustainable Finance strategy even more pressing.

This policy brief identifies three pillars of a progressive approach to greening the European financial system that would render private finance a critical lever in the transition to low carbon economies.

- Ensure that the Taxonomy minimises greenwashing: strict green & degrees of brown;
- Climate-align the ECB: not just green subsidies but also brown penalties;
- Impose a Green FTT.

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Introduction

'The Sustainable Finance agenda is a critical part of the European Green Deal (EGD). It sets public standards for identifying activities that will accelerate the transition to a low-carbon economy (the Taxonomy), standards that can be deployed to steer private finance from brown towards green activities.

The COVID19 global pandemic has rendered the Sustainable Finance strategy even more pressing. While the 'green coalition of the willing' EU Climate Ministers called for a green-centric recovery, in the absence of measures to share some of the fiscal burden of the crisis across Member States, the rapid increases in public debt to GDP ratios will restrict the fiscal room for public investment in green transitions. Under such (political) constraints, the EGD emphasis on leveraging private capital to finance the transition requires closer scrutiny.

This policy brief identifies three pillars of a progressive approach to greening the European financial system that would render private finance a critical lever in the transition to low carbon economies.

1. Ensure that the Taxonomy minimises greenwashing: strict green & degrees of brown.
2. Climate-align the ECB: not just green subsidies but also brown penalties.
3. Impose a Green FTT.

¹ These are: Climate Change Mitigation; Climate Change Adaptation; Sustainable Use and Protection of Water and Marine Resources; Transition to a Circular Economy; Pollution Prevention and Control; Protection and Restoration of Biodiversity and Ecosystems. For more information, see https://ec.europa.eu/commission/presscorner/detail/en/ip_19_6793.

² The Technical Expert Group is in the process of identifying the list of activities and the attending quantitative standards across the six objectives.

³ See https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_en.

1. Ensure that the Taxonomy minimises greenwashing: strict green plus degrees of brown

The Sustainable Finance taxonomy seeks to set public standards for identifying the environmental impact of financial products/instruments. It identifies sustainable activities as those economic activities that make a substantial contribution to at least one of six environmental objectives and causes no significant harm to the others.¹ For this, it defines quantitative thresholds that render an activity 'green' or sustainable.² To then promote green finance, the Commission has pledged to introduce a 'green-supporting factor' in the EU prudential rules for banks and insurance companies that provides regulatory relief for green products.³

However, following intense lobbying from both private finance groups and Member States, the taxonomy now includes three separate categories: sustainable, enabling⁴ and transition.⁵ The reason for introducing the additional categories is to encourage high-emitting companies to shift from 'brown' to the thresholds set by the Taxonomy for 'green' activities, by ensuring that adequate financing for this shift is available. This opens the door for greenwashing not just by introducing an additional layer of complexity in the setting and monitoring of quantitative thresholds, but in restricting the scope for identifying 'brown' activities.

⁴ Enabling activities are defined as those activities that enable other activities to make a substantial contribution to one or more of the objectives, and where that activity: does not lead to a lock-in in assets that undermine long-term environmental goals, considering the economic lifetime of those assets; has a substantial positive environmental impact on the basis of lifecycle considerations.

⁵ Transition activities are defined as those "activities for which there are no technologically and economically feasible low-carbon alternatives, but that support the transition to a climate-neutral economy in a manner that is consistent with a pathway to limit the temperature

This also matters for the growth of a credible Green Bond market. The Sustainable Finance agenda provides a public standard for Green Bonds, defining eligible green projects according to the Taxonomy. It seeks to increase transparency and accountability, by requiring mandatory reporting on allocation and impact, and mandatory verification. However, these marked improvements to transparency and integrity risk morphing into greenwashing if European regulators prioritise the growth of the green bond market by paying heed to financiers' complaints that 'the expected level of stringency in eligibility metrics & thresholds are likely to harm the growth objective for the green bond market'.⁶

Instead, the Taxonomy should provide a strict definition of green in parallel with a 'shades of brown' approach that includes both transition and enabling activities.⁷ The December 2019 political agreement on the Taxonomy Regulation tasked the Commission with extending its work to include a 'brown taxonomy'.⁸ This is a welcome step, and an important opportunity to both rapidly green finance and accelerate the financing of green.⁹

Green activities should be defined to include only those activities that are already low-carbon or enable low-carbon investments. This would exclude the activities that contribute to the transition to a zero net emissions economy in 2050 but do not operate currently at this

level. Only green activities should be identified as (green) Taxonomy-eligible.

In parallel, non-green activities should be assigned a degree of brownness. Transition and enabling activities would qualify as 'low-brown', with the remaining activities 'high brown'. The European Commission should commit to a clear and tight timeline to develop the green/brown taxonomy within the Renewed Sustainable Finance initiative¹⁰.

European institutions, in particular the European Commission together with the European supervisory authorities, should aim to ensure that the Taxonomy is rapidly used in the investment decisions of companies and financial institutions, particularly given the technical complexity and the heavy data requirements. The EU has tools to do so, by for instance integrating the revised Taxonomy in the EU's macro-prudential toolkit – combining green supporting and brown penalising regimes - and other regulatory regimes.

The current position – that the Taxonomy should be a reference framework for disclosure, but private actors can choose between the Taxonomy or private ESG (Environmental, Social and Governance) frameworks – is counterproductive in this respect. Private ESG frameworks suffer from significant shortcomings in terms of comparability, since these are based on

increase to 1.5 degrees Celsius above pre-industrial levels, for example by phasing out greenhouse gas emissions"; see

https://ec.europa.eu/commission/presscorner/detail/en/QANDA_19_6804.

⁶ <https://gsh.cib.natixis.com/eu-green-bond-standard>.

⁷ For a detailed discussion of a green/brown taxonomy and a progressive agenda for greening the macro-financial system, see Gabor, D., Dafermos, Y., Nikolaidi, M., Rice, P., van Lerven, F., Kerslake, R., Pettifor, A. and Jakobs, M. (2019) 'Finance and climate change: a progressive green finance strategy for the UK', Report of the independent panel commissioned by Shadow Chancellor of the Exchequer John McDonnell MP. Available at <https://labour.org.uk/wp->

content/uploads/2019/11/12851_19-Finance-and-Climate-Change-Report.pdf.

⁸ <https://data.consilium.europa.eu/doc/document/ST-14970-2019-ADD-1/en/pdf>

⁹ It is important to note that the integration of the Sustainable Finance taxonomy in regulatory and central bank frameworks will have important, and potentially negative consequences for low-income countries. The European Commission should be mandated to develop a framework of 'brown exceptionalism' that outlines possible exemptions for financial assets issued in low-income countries, where there are no immediate viable substitutes for brown or at least transition activities.

¹⁰ https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_en

proprietary data and non-standardised aggregation methods (for ESG ratings) that can result in confusing¹¹ and conflicting¹² assessments of environmental performance. It risks enabling issuers of ESG assets to engage in greenwashing¹³: by misleading investors about the greenness of the assets they purchase; by allowing for investors to arbitrage ESG-based regulatory frameworks through shopping for high ESG scores across private providers; by creating perverse incentives for ESG rating companies to award high ratings.¹⁴ It also risks a slow adoption of the Taxonomy. Instead, European policy makers should introduce mandatory disclosure according to the green/brown Taxonomy.

Getting the Taxonomy right and implementing it to realign private finance is fundamental to ensuring that the European Green Deal will indeed power a post-pandemic green recovery.

2. Climate align the ECB: green supporting factor and brown penalising factor

Central banks have joined the climate crisis fight through the rapidly growing Network for Greening the Financial System. Their Task-Force on Climate-Related Financial Disclosures (TCFD) proposes a risk-based approach that distinguishes between physical risks arising from extreme climate events and transition risks arising from the implementation of

climate policies such as introducing a brown penalising factor that may leave some assets stranded. While TCFD sets out a framework for financial institutions to disclose the assessment and management of climate risks, the risks-based approaches – different from the impact-based approach of the EU taxonomy – is yet to explicitly consider network and macro-related effects.¹⁵ Put differently, central banks do not possess the conceptual tools to adequately capture the mechanisms through which transitions risks may morph into financial stability risks.

The ECB's monetary policies have an implicit carbon bias. The eligibility criteria for collateral or unconventional purchases do not consider climate risks but rather rely on traditional credit ratings that fail to factor in climate exposures. Thus, monetary policy implicitly sanctions the financial markets' mispricing of climate risks, amplifying the financial stability risks of extreme climate events.¹⁶ This requires the ECB to green its balance sheet. It may choose to do so by citing concerns with transitions risks and resume its policy measures to introducing a green-supporting factor (say a preferential haircut for green collateral) to promote green finance. But given the continuous pressures for easing the technical standards around the three categories of 'green' in the taxonomy, the ECB may end up effectively subsidising greenwashing.

¹¹ Moret, J. (2017). [‘An integrated approach to managing ESG risks and opportunities’](#), Franklin Templeton, 1 April 2017.

¹² Financial Times (2018). [‘Lies, damned lies and ESG rating methodologies’](#), 6 December 2018.

¹³ For example, the world's largest asset manager, and an important issuer of ESG ETFs, Blackrock recently used its shareholder power to block measures against high-carbon companies that would accelerate the transition to a low carbon economy. See Kasargod-Staub, E., (2019). [‘BlackRock and Vanguard protect fossil fuel, energy, and auto execs from facing accountability on climate change’](#), Majority Action, 30 August 2019.

¹⁴ The European Commission recognizes some of these ESG pathways to greenwashing in its 2020 Consultation

on the Renewed Finance Strategy, https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/2020-sustainable-finance-strategy-consultation-document_en.pdf.

¹⁵ For a detailed critique and comparison of risk vs. impact-based approaches, see Gabor et al (2019), https://labour.org.uk/wp-content/uploads/2019/11/12851_19-Finance-and-Climate-Change-Report.pdf.

¹⁶ Yet climate risks raise financial stability issues *within* the existing mandate of central banks (Krogstrup and Oman 2019).

Central banks may err on the ‘incremental changes’ side by prioritising transition risks over physical risks, both in addressing the implicit carbon bias of their monetary policy operations, and in advising European regulators on the appropriate mix of green supporting and brown penalising factors. If the ECB prioritises transition risks, however ill-defined, it may advocate for a green-supporting factor and against a brown penalising factor. Without a strict green/shades of brown Taxonomy, the risk in doing so is that its balance sheet will be put in the service of subsidised greenwashing.

Greenwashing does not just slow the pace of the transition to a low-carbon economy. It also increases the financial stability risks associated with extreme climate events, since it misidentifies as ‘green’ financial assets with significant physical risks attached.

Rather, the ECB should green its balance sheet, and advocate for sustainable finance regulations that combine a green supporting factor with brown penalising factors calibrated according to the degree of brownness of the assets, as identified through the green/degrees of brown Taxonomy proposals above. The scope for green+brown should extend beyond the collateral framework of the ECB and into regulatory regimes for shadow and mainstream banking, especially for Global Systemically Important Banks, whose brown lending across jurisdictions threatens the pace of decarbonisation.

One of the objections that private finance raises to penalising brown assets is that it would have a negative impact on market liquidity, and eventually lead to stranded assets. This however (a) conflicts with the transformative logic of the European Green Deal: it is impossible to seek structural change in the real economy while preserving the

status-quo in the financial sector; (b) a green-supporting factor combined with penalties on brown assets, calibrated according to their degree of brownness, will shift liquidity across asset classes.

3. Reorient the European FTT: a Green FTT

The European Green Deal envisages the use of taxation instruments – such as a carbon border tax – to prevent carbon leakage and create incentives for non-EU countries to join the fight against climate crisis.¹⁷ It could additionally contemplate a Green FTT on brown assets that could be calibrated to (a) target brown assets and (b) remain in place until an adequately brown-penalising framework is wired into the operations of the ECB and broader regulatory frameworks.

The European Commission has fleshed out detailed plans for a broad FTT that would target ‘stock, bond, currency and derivative transactions on exchanges as well as over-the-counter (OTC) traded instruments’. Having passed the European Parliament’s approval, the FTT Directive was brought to a standstill in the Council.¹⁸

Yet the urgency of the climate crisis might break the deadlock and mobilise sufficient political support among EU members, beyond the 10 Member States that have continued to show support for some form of an FTT.

A Green FTT would target all the financial instruments that qualify as brown according to the Taxonomy revised according to the suggestions above. The level of the FTT would be set according to the degree of brownness. A Green FTT would not just raise revenues to invest in a rapid decarbonisation but has the advantage of building on a Directive for taxing finance that would effectively complement the use of a green-supporting factor.

¹⁷ For other related taxes, see www.feps-europe.eu/attachments/publications/book%20united%20for%20climate%20justice%20-%2010.pdf

¹⁸ See www.europarl.europa.eu/legislative-train/theme-deeper-and-fairer-internal-market-with-a-strengthened-industrial-base-taxation/file-financial-transaction-tax.

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OTHER INSIGHTS ON THE TOPIC



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