Financing the Environmental Transition in Europe

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The European Union's commitment to a rapid and concrete transition towards environmental sustainability objectives has become progressively more pervasive and systematic in recent years after the ratification, in October 2016, of the Paris Agreement setting the goal to hold the average global temperature increase well below 2°C compared to pre-industrial levels and to pursue efforts to limit the increase to 1.5°C.

Political and legislative initiatives have touched highly significant moments with: *i)* the Communication on the European Green Deal officially adopted by the European Commission (EC) in December 2019 for a growth strategy consistent with the commitment to achieve no net emissions of greenhouse gas (GHG) in 2050[40], *ii)* the political agreement reached by the European Council in November 2020 on a comprehensive financial package of €1,824.3 billion in which 30% of the total funds are earmarked for the fight against climate change; iii) the European Climate Law of 30 June 2021[41] which has changed to commitment to reach climate neutrality into legally binding obligation for the EU Institutions and Member States and has set the intermediate target of reducing net greenhouse gas emissions by at least 55% by 2030, compared to 1990 levels.

39. Member of the Platform on Sustainable Finance.
40. Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions, *The European Green Deal*, 11 December 2019.
41. Regulation (EU) 2021/1119 of the European Parliament and of the Council of 30 June 2021.

However, the amount of public funds allocated with such a huge financial package is not sufficient to achieve the objectives set by the EU Green Deal[42]. As a consequence, a substantial share of the financing flows has to come from the private sector. This, in turn, makes it essential to introduce incisive reforms in order to enrich the endowment of the financial markets in terms of information, instruments, products, and services, in order to allow private investors to rapidly reorient capital flows towards sustainable investments.

This article intends to review the legislative reforms launched in recent years with this aim and provide some tentative indications on upcoming needs.

1. The Action Plan for Financing Sustainable Growth

The overall strategy for boosting the role of private finance in pursuing environmental and social goals (The Action Plan for Financing Sustainable Growth) was presented by the EC in March 2018[43]. A set of additional complementary initiatives, the so-called Renewed Sustainable Finance Strategy (RSFS), was then announced in July 2021[44].

Consistently with the analytical issues, the set of initiatives contained in the Action Plan aim to: 1) reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth; 2) manage financial risks stemming from climate change, resource depletion, environmental degradation and social issues; 3) foster transparency on environmental factors in corporate communication and public information provided by financial operators and favour long-termism in financial and economic activity.

42. According to the Commission's assessments, Europe will need an estimated EUR 350 billion in additional investment per year over this decade to meet its 2030 emissions-reduction target in energy systems alone, alongside the EUR 130 billion it will need for other environmental goals (Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, *Strategy for Financing the Transition to a Sustainable Economy*, 6 July 2021).
43. Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions, *Action Plan: Financing Sustainable Growth*, 8 March 2018.
44. Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions, *Strategy for Financing the Transition to a Sustainable Economy*, 6 July 2021

Stakeholders need to make investment choices aligned with their appetite for sustainability and to assess the risks that environmental factors pose to the value of their investments. Thus, the Action Plan can be represented as a set of three lines of work centered on a European classification system of sustainable activities (the Taxonomy): (i) initiatives aimed at completing the financial market infrastructure in support of large investors; (ii) reforms aiming at expanding the set of investment opportunities in sustainable activities for retail investors; (iii) potential changes to the financial regulatory framework to increase the consideration of environmental factors in investment decisions and risk management processes of banks and institutional investors.

2. The EU Taxonomy of sustainable economic activities

The Taxonomy Regulation[45] (TR) serves as the cornerstone of the entire Action Plan: establishing a classification system for economic activities that can be univocally defined environmentally "sustainable" provides companies and issuers of securities with a commonly accepted benchmark to demonstrate their current and future commitment in sustainable activities and to qualify the request for funds. Moreover, the Taxonomy makes it possible for financial market participants (FMPs) and retail savers to seize eco-sustainable investment opportunities without the risk of incurring into greenwashing.

The TR considers six environmental objectives; (a) climate change mitigation; (b) climate change adaptation; (c) the sustainable use and protection of water and marine resources; (d) the transition to a circular economy; (e) pollution prevention and control; (f) the protection and restoration of biodiversity and ecosystems.

An economic activity can be defined sustainable if it: 1) contributes substantially to one or more of the six environmental objectives; 2) does not significantly harm any of the remaining environmental objectives; 3) is carried

45. Regulation (EU) 2020/852 of 18 June 2020.

out in compliance with the minimum safeguards[46] 4) complies with technical screening criteria (TSC) established by delegated acts adopted by the EC.

The TSC are meant to identify the conditions that determine both the substantial contribution (SC) and a significant harm (SH) to each environmental objective: they must be based on scientific evidence and the precautionary principle embedded into the European legislation; they must be quantitative and contain thresholds to the extent possible, and otherwise be qualitative; they have to be periodically reviewed to remain aligned with scientific and technological developments[47].

In addition to economic activities that directly make a substantial contribution to one or more of the environmental objectives without causing significant harm to any of the other objectives, the Taxonomy qualifies as sustainable: a) the activities (*transitional activities*) which cannot yet be replaced by technologically and economically feasible low-carbon alternatives but support the transition to a climate-neutral economy by presenting the greenhouse gas emissions levels (GHG) corresponding to the best performance in the sector or industry, and; b) those (*enabling activities*) which do not substantially contribute to climate change mitigation through their own performance but by directly enabling other activities to make a substantial contribution to one or more of the six environmental objectives.

Parallel to the completion of the overall design of the Taxonomy with the definition of TSC, works are being carried out for the possible extension of its scope of application. Regulation (EU) 2020/852 itself requires the Commission to publish a report describing the provisions that would be required to extend the classification system to cover economic activities that do not have a significant impact on environmental sustainability (NSI) and economic activities that significantly harm environmental sustainability and to broaden the range of sustainability objectives to social objectives.

46. As developed in the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights.

47. A first set of TSC has already entered into force: for a large number of economic activities, the conditions under which it can be said that a significant contribution to one of the two climate objectives (mitigation and adaptation) is made and a significant harm to any other environmental objective is caused are established (Commission Delegated Regulation (EU) 2021/2139 of 4 June 2021). A second Taxonomy Complementary Climate Delegated Act on climate change mitigation and adaptation covering the natural gas and nuclear energy sectors has been presented by the EC on 2 February 2022 in order to be formally transmitted to the co-legislators for their scrutiny.

At the same time, the Regulation established a Platform on Sustainable Finance[48] with the mandate to provide advice to the Commission on the suitability and feasibility of these amendments; the TSC and the possible need to develop, update or revise those criteria and on their usability; the evaluation and development of sustainable finance policies.

3. Initiatives aiming at supporting large investors

3.1. Corporate Communication

At the entry into force of the TR, the main source of company information on environmental factors was Directive 2014/95/EU (the Non-Financial Reporting Directive, NFRD) requiring large public-interest entities[49] with an average number of employees in excess of 500 to report both on how sustainability issues affect their performance, position and development (the 'outside-in' perspective), and on their impact on people and the environment (the 'inside-out' perspective) (*double materiality approach*). According to the TR (Art. 8) the entities that are in the scope of the NFDR have to disclose, in addition, information on how and to what extent their activities are Taxonomy compliant.

The key performance indicators to be disclosed by non-financial undertakings are specified directly in the Regulation: the proportion of their turnover derived from products or services associated with sustainable activities and the proportion of their capital expenditure and the proportion of their operating expenditure related to assets or processes associated with sustainable economic activities. The content and format of the disclosure obligations of financial undertakings have been defined by the Commission Delegated Regulation (EU) 2021/2178 of 6 July 2021, which applies from 1 January 2022. As for credit institutions, the key performance indicators show

48. The Platform, which constitutes an independent Expert Group, includes representatives of European institutions, member chosen in the industrial and financial sectors, experts representing civil society, academics and researchers, and experts appointed in a personal capacity.

49. Public-interest entities in the EU include entities governed by the law of a Member State whose transferable securities are admitted to trading on a regulated market of any Member State, credit institutions, insurance undertakings, and entities designated by Member States as public-*interest entities, for instance due to the nature of their business, their size or the number of their* employees (Directive 2013/34/EU, the Accounting Directive, and Directive 2014/56/EU, the Audit Directive).

the share of the business related to Taxonomy-aligned economic activities separately for on-balance sheet assets (the green asset ratio for loans and advances/debt securities/ equity instruments); off-balace sheet items arising from holding assets under management and providing financial guarantees; fees and commission income derived from commercial services and activities; trading activity.

In the Action Plan, the EC announced forthcoming measures to meet the need to improve the quality of corporate communication on environmental issues. As also emerged from a public consultation launched in February 2020[50], the information provided was considered lacking in terms of comparability, reliability and effective relevance; the plurality of possible communication channels hindered the joint finding and use of information released by different companies which, in addition, were rarely available in a machine-readable digital format; the limited number of reporting entities severely limited the scope of assessments by investors and other stakeholders.

The Proposal for a new Corporate Sustainability Reporting Directive (CSRD) published in April 2021 contains important changes: a) it extends the scope of the reporting requirements to all large companies and listed companies (from approximately 11,700 to nearly 50,000); b) it requires the audit of reported sustainability information; c) it specifies in more detail the information that companies should provide according to sustainability reporting standards to be developed by the European Financial Reporting Advisory Group (EFRAG) and consequently adopted by the EC; d) it requires that all information is published as part of companies' management reports, and disclosed in a digital, machine-readable format in order to be included in the European Single Access Point. According to a proportionate approach, no mandatory reporting requirements are imposed on small and medium-sized enterprises (SMEs), except those listed on EU regulated markets[51]. Moreover, the EC will adopt standards for large companies and separate, proportionate standards for listed SMEs to be used on a mandatory basis, while non-listed SMEs will decide whether to use them on a voluntary basis.

50. European Commission (2020).
51. Moreover, listed micro-companies are exempted from mandatory reporting obligations.

3.2. EU Climate Benchmarks

In the Action Plan, the EC noted the increasing demand for benchmarks suitable for measuring the environmental performance of financial portfolios. In response, the market was offering a plethora of indices which, despite differences in objectives and methodologies, were proposed as low-carbon.

In order to increase the comparability between benchmarks, provide a tool to support climate-focused investments, and increase transparency with respect to the impacts of investments, Regulation (EU) 2019/2089 of 27 November 2019 introduced two types of climate benchmarks: the EU Climate Transition Benchmarks (EU CTB) and the EU Paris-Aligned Benchmarks (EU PAB) and established ESG disclosure requirements applicable to all registered benchmark administrators[52].

The two new climate benchmarks incorporate specific targets of reducing greenhouse gas emissions, through the choice and weighting of the underlying assets. They entail different ambition levels: a) the EU PABs have stricter demands, including alignment with the Paris Climate Agreement global warming targets and a 50% lower weighted average GHG intensity than the investable universe, and they are designed for institutions actively pursuing the Paris climate goals; b) the EU CTBs require a 30% lower GHG intensity than the investable universe and are primarily intended for diversification strategies with a focus on climate risk mitigation.

For EU PABs and EUCTBs, benchmark administrators are requested to disclose in their benchmark statements details on whether or not and to what extent a degree of overall alignment with the target of reducing GHG emissions or the attainment of the objectives of the Paris Agreement is ensured and to publish the methodology used for the calculation of those benchmarks.

3.3. EU Green Bond Standard

At the time the Action Plan was prepared, the green bond market, although rapidly expanding, was not considered large enough to support the transition towards climate mitigation targets and appeared to be affected by

52. ESG disclosure requirements are applicable to all investment benchmarks, with the exception of currency and interest rate indices whose underlying assets don't have any impact on climate change. Commission Delegated Regulation (EU) 2020/1817 of 17 July 2020 has defined the minimum content of the explanation of how the key elements of the benchmark methodology reflect ESG factors for each benchmark and a standard format to be used for such disclosure.

some barriers[53]: 1) uncertainty about the actual quality of the financed projects in terms of environmental performance; 2) high operating costs associated with the procedures necessary for the issue; 3) reputational risks for the issuers if the market doesn't consider the project to be financed sufficiently green or if the project fails to achieve the announced environmental objectives.

Building on such analysis, the EC has developed a Proposal for an EU Regulation on European green bonds which was presented on 6 July 2021 defining a robust EU Green Bond Standard (EUGBS) to be made available to issuers for voluntary adoption.

The overall proposed discipline comprises four components: (1) Taxonomy-alignment of use of proceeds: the proceeds shall be exclusively and fully allocated to economic activities that meet the taxonomy requirements currently or within a defined period of time[54]; (2) well defined issuing procedures: the issuers are required to publish a European green bond factsheet showing the intention to adhere to the EU GBS Regulation, information on how the bond aligns with the broader environmental strategy of the issuing entity, the environmental objectives pursued by the bond, a description of the processes by which the issuer will determine how projects align with the taxonomy requirements, the time schedule along which the proceeds will be allocated to the projects; (3) a reporting regime articulated into an 'allocation report' to be drawn up every year by the issuers demonstrating that the proceeds of the European green bonds have been actually allocated in accordance the Regulation and an 'impact report' on the environmental impact of the use of the bond proceeds to be published after the full allocation of the proceeds of the green bonds and at least once during the lifetime of the bond; (4) an external review requirement: all pre-issuance and post-issuance public information has to be 'certified' by external reviewers registered with ESMA and complying with a series of requirements regarding their governance, prevention of conflicts of interest, organisational structure, sound and prudent management, assessment methodologies and knowledge

53. EU Technical Expert Group on Sustainable Finance (June 2019).
54. The period shall not exceed five years from bond issuance, unless a longer period of up to ten years is justified by the specific and documented features of the economic activities concerned, as foreseen in the Commission Delegated Regulation (EU) 2021/2178 of 6 July.

and experience of the analysts; (5) a supervisory system centered on ESMA, for which the supervisory and investigatory powers of the competent authorities and administrative sanctions and other administrative measures are provided in detail.

3.4. Sustainability in credit rating and ESG scoring services

The Action Plan noted the proliferation of services for the evaluation of companies' ESG performance. Lack of transparency on data sources and methodologies made it extremely difficult to assess which of the scores was more reliable[55]. On the other hand, there was no clarity on the extent to which sustainability factors were included in credit ratings and according to which methodologies.

Consequently, the EC made a commitment to carry out a comprehensive study on sustainability ratings and research and invited ESMA to assess the current practice within the credit rating market concerning sustainability considerations. ESMA was also invited to include environmental and social sustainability information in its guidelines on disclosure for credit rating agencies (CRA), and to consider additional guidelines or measures, if needed.

In the Technical Advice published on 18 July 2019 ESMA confirmed that ESG factors are included in the creditworthiness assessments with heterogeneous methodologies but expressed the opinion that credit ratings should remain distinct from sustainability assessments. Updating disclosure requirements on how ESG factors are treated by credit rating agencies (CRA) were considered preferable to mandating the consideration of sustainability characteristics in CRA's credit assessments. In this vein, ESMA published new guidelines requiring greater transparency around whether and why ESG factors are a key driver of the credit rating action[56]. As shown in a recent study[57], although the overall level of disclosure has increased, significant divergencies remain in CRAs' disclosures even for rated entities that are highly exposed to ESG factors. As a consequence, ESMA expresses the commitment to continue analysing the underlying drivers of the observed

55. Doubts arised from the low degree of correlation between the ESG scores available to investors, ranging from 0.4 to 0.7, vis a vis the correlation between credit ratings (above 0.9), see Berg F. et al. (2019).
56. See ESMA (2019).
57. See Amzallag et al. (2022).

heterogeneity and to consider the appropriate supervision and policy tools for further transparency.

As regards the ESG rating sector, in January 2021 ESMA signalled the need to ensure the quality and reliability of assessments and stem the risk of greenwashing[58]. A common definition of ESG ratings was considered a necessary prerequisite for a regulatory and supervisory framework including an authorization and registration discipline and minimum subjective requirements in terms of organization, transparency and prevention of conflict of interest that can be suitable for both large multi-national providers and smaller entities. ESMA declared to be ready to support possible future supervisory responsibilities in this area. Moreover, in order to gather information on the market structure for ESG rating providers in the EU, on 3 February 2022 ESMA launched a call for evidence addressed to ESG rating providers and users, and to entities subject to ESG assessments.

4. Initiatives aiming at supporting retail investors

4.1. Sustainability-related disclosures in the financial services sector

In the Action Plan it was noted that, although investors and asset managers are required to act in the best interest of the end-investors, they do not systemically consider sustainability factors and risks in their investment/advice decisions and disclosure processes.

In order to reduce information asymmetries in principal-agent relationships with regard to environmental factors and risks and to the impact of investment decisions on sustainability factors, Regulation (EU) 2019/2088 of 27 November 2019 (Sustainable Finance Disclosure Regulation, SFDR) introduced new requirements for financial product manufacturers and financial advisers both at entity level and at product level.

At the entity level, FMPs and financial advisers are required to disclose on their websites information on their policies to consider principal adverse impacts (PAIs) of investment decisions (made or suggested), for which the definition of content, methodologies and presentation is entrusted to the ESAs. In pre-contractual disclosures, FMPs/financial advisers must include

58. See ESMA (2021).

descriptions of how sustainability risks are integrated into the investment decisions (made or suggested) and of the likely impacts of sustainability risks on the returns of the financial products they make available/advise on.

At product level, FMPs are required to explain whether and how a financial product considers PAIs on sustainability factors. For financial product promoting environmental and/or social characteristics, pre-contractual disclosure must include information on how those characteristics are met and, if an index has been designated as a reference benchmark, information on whether and how this index is consistent with those characteristics. Where a financial product has sustainable investment as its objective and an index has been designated as a reference benchmark, pre-contractual disclosure disclosed must contain information on how the designated index is aligned with that objective and an explanation as to why and how the designated index aligned with that objective differs from a broad market index. For both the promotion of environmental or social characteristics and sustainable investments, FMPs are required to publish on their websites a description of the environmental or social characteristics or the sustainable investment objective and information on the methodologies used to assess, measure and monitor the environmental or social characteristics or the impact of the sustainable investments selected for the financial product.

4.2. Sustainability considerations in financial advice

As observed in the Action Plan, investors' preferences regarding sustainability are often not sufficiently taken into account by investment firms and insurance distributors in the phase in which they assess clients' investment objectives and risk tolerance in order to recommend suitable financial instruments or insurance products. For this reason, changes to the Markets in Financial Instruments Directive (MiFID II) and to the Insurance Distribution Directive (IDD) delegated acts were announced.

In fact, on 21 April 2021 the EC amended existing delegated acts by introducing the assessment of client's sustainability preferences in the suitability assessment.

Insurance and investment advisers are required to obtain information not only about the client's financial expertise and ability to bear losses but also

about their sustainability preferences in order to assess the range of financial instruments and products to recommend. To prevent the risk of greenwashing, it is established that, in order to be recommended to customers as responding to any expressed sustainability preference, any financial instrument or insurance-based investment product *a)* must finance Taxonomy-aligned economic activities for a minimum proportion determined by the client; *b)* must finance sustainable investments as defined in the SFRD for a minimum proportion determined by the client; *c)* must consider PAIs on sustainability factors as defined in the SFRD where qualitative or quantitative elements demonstrating that consideration are determined by the client.

4.3. The EU Ecolabel for retail financial products

In order to facilitate retail investors to express their preferences in terms of sustainability and for an easier access to sustainable financial products, the Action Plan considered the potential merit of a voluntary labelling scheme for financial products unequivocally connected with sustainable activities.

Work carried out at the Joint Research Center of the EC has resulted in a set of proposals that have been refined over time. According to the document released in March 2021[59], financial products can be labelled as sustainable if, among other requirements, they: invest in Taxonomy-aligned activities to an extent not lower than a certain threshold; do not finance companies that derive more than 5 percent of their turnover from a specific list of activities considered harmful to environmental objectives; do not finance companies that do not meet certain criteria relating to social aspects or are not in line with good corporate governance practices; are offered by fund managers engaging with financed entities in order to obtain improvements in their environmental performance. The preparation of a specific European regulation is currently underway.

59. See Konstantas et al. (2021).

5. Sustainability in the prudential framework of credit institutions

At the time of the Action Plan, alarmed warnings had already been issued for the exposure of the financial system to the risks associated with climate change. Mark Carney had evoked the Tragedy of the horizon and had introduced the classification of climate risks (physical, transition, and liability risks) which has now become the common point of reference[60].

The Action Plan showed concern that environmental risks were not adequately considered in business strategies and risk management systems of credit institutions and insurance companies and that capital requirements should better reflect the risk of sustainable assets. As a consequence, EIOPA and EBA were mandated to assess the potential inclusion of ESG risks in the prudential regulatory frameworks and to elaborate on how the institutions could better identify, assess and manage ESG risks[61].

In compliance with the mandate, in June 2021 EBA Report issued a report[62] containing an overview of bank current practices and a set of recommendations aimed at integrating ESG risks[63] into the definition of bank business strategies, internal governance structures, and risk management systems[64]. As for business strategies, EBA pointed out the need of extending the time horizon for strategic planning (to at least 10 years) consistently with the materialisation horizon of ESG risks and of testing their outcomes under different scenarios. Setting, disclosing and implementing ESG risk-related strategic objectives and/or limits was also recommended, as well as engaging with borrowers and investee companies, if appropriate by referring to taxonomies. Regarding governance arrangements, special attention was given to the role of the management body in establishing an ESG risk culture, setting the risk appetite, ensuring that tasks and roles relating to

60. See Carney (2015).
61. For EIOPA the mandate was given in the Action Plan; for EBA the mandate regarding credit institutions and investment firms (the institutions) was contained in Article 98(8) of Directive 2013/36/EU (Capital Requirements Directive - CRD) and in Article 35 of the Directive (EU) 2019/878.
62. See EBA (2021).
63. Defined as as risks that stem from the current or prospective impacts of ESG factors on bank counterparties or invested assets and fall into the traditional categories of financial risks (credit risk, market risk, operational and reputational risks, liquidity and funding risks).
64. On the same issues, in November 2021 the Basel Committee for Banking Supervision published a Consultation Document on *Principles for the effective management and supervision of climate-related financial risks.*

ESG risks are clearly and effectively allocated between internal structures. For risk management, the focus was on the operational and methodological challenges connected with the lack of data to identify and measure ESG risks, the difficulty of developing ESG risk metrics, in-house scoring system and risk models, scenario analysis and stress-testing tools, also due to the fact that a much longer time horizon becomes relevant than that currently considered. Despite these difficulties, credit institutions were recommended to include ESG risks in their risk appetite framework and describe their risk tolerance along with the resulting thresholds and limits in their ICCAP and ILAAP; collect information on the exposure of their counterparties to ESG risks, especially in the loan origination phase.

Integrating ESG risks into the Supervisory Review and Evaluation Process (SREP) performed by competent authorities under Pillar 2 of the prudential regulation encounters difficulties that are very similar to those experienced by credit institutions. Specific attention should be given to how ESG factors affect the business environment and the viability and sustainability of the business model and on whether institutions sufficiently test the resilience of their business model against the time horizon of the relevant public policies or broader transition trends. Scenario analysis and stress testing should be used to assess the long-term resilience of institutions and their vulnerabilities in terms of capital, liquidity, and funding.

The EBA recommendations to both credit institutions and supervisors have been widely taken into account by the EC in developing the Banking Package presented on 27 October 2021, that finalises the implementation of the Basel III agreement in the EU. New, formal requirements for institutions to systematically identify, measure and manage ESG risks are introduced and regular climate stress testing activity has to be implemented by both banks and supervisors. Pillar 3 disclosure requirements for ESG risks are expanded from only applying to large, listed institutions to all in the scope of the CRR, in such a way to respect the proportionality principle[65].

65. On 24 January 2022, EBA published draft implementing technical standards (ITS) on Pillar 3 disclosures on ESG risks, putting forward comparable disclosures to show how climate change may exacerbate other risks within institutions' balance sheets, how institutions are mitigating those risks, and their ratios on exposures financing taxonomy-aligned activities, including a green asset ratio and a banking book taxonomy alignment ratio.

In redefining and completing the prudential framework of banking activity, the EC took the opportunity to return to an issue already touched upon in the Action Plan and never abandoned: the potential calibration of capital requirements that could be justified from an ESG risk perspective. In the Proposal for amending CCR, EBA is mandated to deliver a report on the prudential treatment of bank exposures by 2023[66].

While in the Action Plan the attention seemed to be put on sustainable activities deserving a supporting factor in relation to their lower exposure to ESG risks[67], in the Proposal for amending CCR the assessment EBA is called upon to carry out regards "a targeted calibration of a risk weights for items associated with particularly high exposure to climate risk, including assets or activities in the fossil fuel sector and in high climate impact sectors". In any case, the EC's attitude seems to mainly reflect the objective of channeling funding flows towards environmental objectives, which could find support in the expected lower exposure of sustainable activities to environmental risks and in some empirical analyses showing that companies that focus on sustainability benefit from higher cash flows, greater earnings stability, better credit ratings, and lower market premia[68].

However, as emerged from a survey conducted by the Basel Committee in 2020[69], most members have not yet factored the mitigation of climate-related financial risks into their prudential capital framework. A series of considerations probably explain the reluctance of regulatory authorities and supervisors to adopt an 'economic policy approach'. As for the green supporting factor, introducing a new source of risk is hardly consistent with reducing the capital charge, which for assets financing sustainable activities could at most remain unchanged. Moreover, there is no certainty that an advantage in terms of capital requirements would translate into an increase

66. In parallel, in the framework of a comprehensive review of EU insurance rules ("Solvency II") on 23 September 2021, EIOPA has been mandated to explore by 2023 a dedicated prudential treatment of exposures related to assets or activities associated substantially with environmental and/or social objectives and to review regularly the scope and the calibration of parameters of the standard formula pertaining to natural catastrophe risk.
67. "the Commission will assess whether more appropriate capital requirements could be adopted to better reflect the risk of sustainable assets held by banks and insurance companies. Such a supporting factor would need to be progressively phased in, as the EU taxonomy develops" (p. 9).
68. Analytical arguments and empirical analyses are contained in Carney, M (2019a,b) and in Alessi et al. (2020).
69. See Basel Committee on Banking Supervision (2020).

in financing sustainable activities; the experience with the SME adjustment factor is not conclusive. A brown penalizing factor would align bank capital to higher transition risk of certain activities but could hit non financial companies which need funds to improve their ESG performance and amplify the risks in the long period. But, more importantly, in order to fully integrate ESG risks in banks' balance sheet, it is essential to accurately measure the ESG risks associated to each asset, not only to the green or the brown. However, at the present time measuring risk differentials stemming from a different impact of ESG factors on the various assets encounters the already mentioned difficulties in terms of data, risk metrics and forward-looking assessment models[70].

6. An Extended Taxonomy for a strenghtened Action Plan?

As already mentioned, Art. 26 of the TR provides for the possibility of extending the scope to cover activities that do not have a significant impact on environmental sustainability and economic activities that significantly harm environmental sustainability and the newly created Platform for Sustainable Finance (Art. 20) has been mandated to advise the Commission on the possible need to amend the TR. The final Report of the Platform, published on 28 March 2022, contains both an analysis of the pros and cons of an Extended Taxonomy (ET) and a set of recommendations for a smooth and effective introduction of the two new categories activities in the TR[71].

The main pro of an ET is that, once the TSC are completely defined, it would make it possible to classify all the economic activities carried out by a company, by a productive sector, by an entire economy with respect to environmental objectives and, consequently, the environmental performance of the assets in financial portfolios. At the same time, this would avoid a recurrent binary misinterpretation of the current Taxonomy, according to which activities unable to report as sustainable are considered unsustainable[72],

70. The debate between a risk approach and an economic policy approach is carefully reviewed in Berenguer et al. (2020).
71. See Platform on Sustainable Finance (2021).
72. See, for example, the statement in Carney, M. (2019).

which could distort the allocation of funds on the financial markets. Finally, an ET would also allow credit institutions and financial investors to recognize and support investment plans that put an end to harmful environmental performance and achieve a stable improvement in environmental performance.

The Platform notes that the building blocks of an ET are already contained in the current TR, given that for each environmental objective it is defined what is meant by significant harm (SH) (art. 17) and that TSC are required (Art. 10-15) that specify the conditions identifying SH (Art. 19(1)). As a consequence, failing such TSC is technically equivalent to causing SH.

While for activities violating the TSC for SH, technological solutions are available that allow to improve the environmental performance, there are other activities for which no such technological possibility of improving exists. The Platform recommends that the activities in such a situation be identified, in addition to the activity of power generation from fossil fuels mentioned in Art. 19 (2) of the TR. The whole set of harmful activities would therefore have two components which do not differ in terms of how harmful they are but in terms of future perspective: the activities for which no possibility of improvement exists can only be decommissioned while the others can be either decommissioned or undergo an investment plan for improving their environmental performance.

This implies that the TR technically defines three levels of environmental performance: 1) sustainable; 2) harmful; 3) intermediate (for activities doing no significant harm to environmental sustainability nor providing any SC). It is important to note that being in the intermediate area is not the same as having no (or low) significant impact (NSI) on environmental objectives and that proactively identifying a classification of NSI activities would support businesses to show that the activities they carry out are not harmful.

However, the classification of economic activities on three levels cannot be given regulatory power, for the fact that the scope of application of the TR, as defined in Art, 1(1), is limited to establishing "the criteria for determining whether an economic activity qualifies as environmentally sustainable for the purposes of establishing the degree to which an investment is environmentally sustainable".

For this reason, the Platform recommends that the Taxonomy should be extended, with a priority given to the classification of significantly harmful

activities in order to timely identify the activities for which either the dismissal or transition plans towards better environmental performance, even if not yet sustainable ('intermediate transition'), are urgent and possible. If compliant with specific requirements in terms of credibility and science-based ambition of the improvement and framed in the long-term environmental strategy of the company, such 'intermediate transition investments' could be recognised in the EU legislation for sustainable finance in order to receive support by private financial investors.

According to the Platform, it would be essential that ET be part of a wider set of EU policy and legislative initiatives aimed at incentivizing finance for urgent transition away from environmentally significantly harmful activities. Indeed, due to its role as cornerstone, the ET would release strong synergies with legislation launched as part of the Action Plan amplifying their effects. Some examples can be provided for further reflection.

For large investors, the possibilities of channeling funds towards environment friendly projects would increase in relation to the wider set of information disclosed by non-financial undertakings which would also broaden the effects of the proposed CSRD. Corporate communication, no longer limited to sustainable activities, would allow to identify intermediate transition investments. Building on the ET and the extended reporting obligations, the forthcoming legislation on the EU GBS could be enriched by merely applying the use-of-proceeds approach to bonds issued to finance intermediate transition plans that have the necessary requirements. New forms of sustainability linked loans and bonds could be designed by aligning terms and conditions to the implementation of an intermediate transition plan.

Retail investors could have the possibility of expressing their preferences regarding sustainability in a more articulated way by making reference to supporting intermediate transition, which would establish significant synergies with the changes made in the Mifid II and IDD delegated regulations. The effects of the planned EU Ecolabel for environment friendly financial product could also be strengthened by introducing a specific label for retail financial products respecting specific thresholds defined considering the proportion of the underlying investments invested in intermediate transition plans. Financing intermediate transition investments could be considered under the SFDR for providing information on how and to what

extent the investment underlying a financial product can qualify as financing an intermediate transition plan. It could also be investigated the possibility of coordination between the concept of PAI and that of SH in the context of both the SFDR and the regulation on financial advice.

Credit institutions and supervisors would be given an important tool to qualify the assets that are more exposed to environmental risks to be used in defining business planning, credit policies, engagement policies with borrowers and investee companies, risk management systems, stress testing exercises, and governance arrangements, and, as a consequence, to be considered in supervisory reviews and in macroprudential analysis[73].

Implementing the ET would require the need for further reflection, impact analyses, review of some published DNSH criteria, amendments to EU legislation both already in force and to be enacted, that is a series of steps whose complexity cannot be denied. However, to promote a voluntary use of ET concepts to submit transition investment plans to financial markets or to develop financial instruments specifically linked to intermediate transition objectives could accelerate the drive for better environmental performance in the EU.

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73. It is for this reason that the Network for Greening the Financial System was among the first to put forward the proposal for a taxonomy classifying not only green activities but also "bown" activities (NGFS, 2019).

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