EUROPEAN POLICY CENTRE

DISCUSSION PAPER

SUSTAINABLE PROSPERITY
FOR EUROPE PROGRAMME

13 JULY 2022

Achieving the full potential of sustainable finance: The role of national, European and international initiatives

Eva De Francesco

Credit: PIXABAY

Table of contents

List of acronyms 3

Executive summary 4

Introduction 5

Sustainable finance, an evolving ecosystem 5

The regional, EU approach 6

Selected national approaches targeting greenwashing outside the EU 8

Global baseline standards searching for a global compromise 9

Recommendations 11

Conclusion: The prospects for sustainable finance 12

Endnotes 13

ABOUT THE AUTHOR

Eva De Francesco is an EPC External Adviser.

ACKNOWLEDGEMENTS/DISCLAIMER

This publication is an outcome of an EPC project on sustainable finance, which was supported by the UK Mission to the EU. In drafting this paper, the EPC relied on extensive background research and interviews with sustainable finance policy experts from the ranks of EU institutions, central banks, international organisations, the private sector and NGOs. The author wishes to thank Frédéric Vonner, Advisory Partner at PricewaterhouseCoopers Luxembourg; Robert Youngman, Team Leader, Climate Finance and Investment at the Organisation for Economic Co-operation and Development; Olivier Boutellis-Taft, CEO of Accountancy Europe; Julia Linares Sabater, Senior Sustainable Finance Policy Officer at the World Wildlife Fund (WWF); Henry Eviston, Sustainable Finance Policy Officer at WWF; Edo Schets, Manager at the Bank of England's Climate Hub; and two other interviewees for sharing their insights. The author would also like to thank Emi Vergels at the EPC and Gareth Davies at the UK Mission to the EU. The views and opinions expressed in this paper are those of the author. They do not purport to reflect the opinions or views of the author's present or past employers.

The support the European Policy Centre receives for its ongoing operations, or specifically for its publications, does not constitute an endorsement of their contents, which reflect the views of the author only. Supporters and partners cannot be held responsible for any use that may be made of the information contained therein.

UK Mission to the European Union

Visuals created by Jon Wainwright.

List of acronyms

CCDA	Complementary Climate Delegated Act
COP26	2021 UN Climate Change Conference
CSRD	Corporate Sustainability Reporting Directive
ECJ	European Court of Justice
EFRAG	European Financial Reporting Advisory Group
ESG	environmental, social and corporate governance
ESRS	European Sustainability Reporting Standards
GRI	Global Reporting Initiative
ISSB	International Sustainability Standards Board
MEP	Member of the European Parliament
PSF	EU Platform on Sustainable Finance
SFDR	Sustainable Finance Disclosure Regulation
TCFD	Task Force on Climate-Related Financial Disclosures
US SEC	US Securities and Exchange Commission

Executive summary

When signing the 2016 Paris Agreement, a legally binding international treaty on climate change, world leaders agreed to pursue the ambitious goals of achieving climate neutrality and mitigating the effects of climate change. Almost every country around the globe recognised that business-as-usual is not an option if we are to save the planet and human existence. As a result of this realisation and commitment, different green measures are being taken globally, regionally, locally; at all levels of societies; and in the public and private sectors.

Redirecting capital flows toward a green economy is an important part of measures to take, so it is no surprise that there is a growing interest in using environmental, social and corporate governance (ESG) factors as guidance points for both public and private investors.

However, there is still much to be done to ensure not just sufficient investment volumes but also that investments labelled as 'sustainable' do, in fact, contribute to climate action objectives. In order to realise ESG markets' full potential in supporting the global transition towards a climate-neutral economy, further effort is especially needed in the following three areas:

1. Policymakers at all levels must urgently address 'greenwashing' and the lack of transparent and comparable ESG data. Greenwashing not only undermines investor trust and thus slows down the expansion of ESG markets but also negatively impacts the effectiveness of ESG investments in driving the net-zero transition. Regulators at the national, regional and international levels should continue to improve data availability and transparency by integrating sustainability into financial market regulation and governance. The EU's experience in developing a sustainable finance taxonomy showed the complexity of bringing together the dialogues on political interest and scientific understanding of climate change. Policymakers developing green taxonomies elsewhere should focus on facilitating a process where both scientific and political realities of transitioning to climate neutrality are addressed transparently.

2. In the context of sustainability reporting, double materiality approaches are better suited to address the urgency of climate change. Sustainability reporting can play an important role in the transition to climate neutrality by providing accurate and comparable information. Double materiality approaches – providing information about the impact of sustainability issues on companies as well as companies' impact on the environment and society – should be promoted wherever possible. Enabling a global compromise on baseline reporting standards and avoiding gridlocks requires a certain level of pragmatism. Dynamic and financial materiality approaches which consider environmental and societal issues only as long as they impact enterprise value are more likely to be accepted globally, provided that they remain interoperable with double materiality approaches.

3. Policymakers at all levels must ensure the interoperability and alignment of the rapidly evolving sustainability reporting initiatives. The new regulatory interventions at national and regional levels can improve the transparency and reduce the complexity of the ESG ecosystem. At the same time, in the absence of international cooperation, regulatory competition between countries could undermine the efforts to improve the functioning of the global ESG ecosystem. Divergent national and regional ESG disclosure standards could add transaction costs and complexity for businesses. Climate change is a global phenomenon that requires global coordination. This is even more true for the finance sector.

Introduction

When the Paris Agreement entered into force in November 2016, the world set on the course of addressing the greatest environmental challenge affecting our current and future generations. And yet, as concluded last year at the 2021 UN Climate Change Conference (COP26) in Glasgow, not enough is being done to slow down climate change. The current pledges would only limit global warming to about 2.4°C. Climate action must be sped up to keep the 1.5 °C goal alive.[1]

To deliver on the national, regional and international pledges, initiatives and commitments announced in Glasgow, substantial volumes of finance and investment will need to be mobilised. McKinsey & Company, for example, estimates that "capital spending on physical assets for the net-zero transition between 2021 and 2050 would be about $275 trillion."[2]

With the capacity to tap into vast volumes of mainstream private finance and redirect it towards climate action, ESG investments could play a significant role on the world's path to climate neutrality. But this will only be possible if and when transparent, comparable and reliable data on ESG matters become part of mainstream corporate reporting.

COP26 also delivered an important milestone for impact investing that pays attention to environmental, social and corporate governance (ESG) considerations. The establishment of the International Sustainability Standards Board (ISSB) was announced in Glasgow. Its goal is to develop a global baseline of sustainability-related disclosure standards. Labelled by *Forbes* as a "giant leap" forward and "the biggest change in corporate reporting since the 1930s",[3] the importance of the forthcoming standards cannot be overstated. With the capacity to tap into vast volumes of mainstream private finance and redirect it towards climate action, ESG investments could play a significant role on the world's path to climate neutrality. But this will only be possible if and when transparent, comparable and reliable data on ESG matters become part of mainstream corporate reporting.

Recognising the urgency posed by climate change, policymakers across many jurisdictions around the globe have embarked on a regulatory "race" to improve the functioning of ESG markets at national, regional and international levels.[4] Besides the founding of the ISSB, notable examples include the EU's sustainable finance strategy, including its taxonomy classification system for sustainable activities; the UK's Green Finance Strategy; and the US Securities and Exchange Commission's (US SEC) proposal to enhance and standardise climate-related disclosures for investors.

Regulations and standards are about to play a crucial role in helping ESG investors determine sustainable activities. By setting standards, national, regional and global policymakers can improve the transparency and efficiency of ESG investments supporting climate action. Ultimately, regulations and standards are a necessary tool for mainstreaming sustainable finance. However, standardised disclosure rules and improved ESG data transparency alone will not be enough to attract the investment volumes necessary to achieve the Paris Agreement goals. Although not the focus of this Discussion Paper, it is important to note that improved ESG data transparency must be complemented with broader enabling economic policies like carbon tax and trading schemes to nudge economic actors into stimulating demand for ESG assets and achieving the Paris Agreement goals.

This Discussion Paper explores the major policy developments in the sustainable finance sector. Specifically, it provides an overview of the evolving sustainable finance ecosystem and examines significant challenges and opportunities for mainstreaming sustainable finance. It studies lessons learned in the EU, particularly efforts to establish global rules and their interplay with national and regional initiatives. Finally, it provides recommendations for national, regional and global policymakers and standard-setters.

Sustainable finance, an evolving ecosystem

Sustainable finance has great potential to redirect much-needed finance to climate action and the global transition to a climate-neutral economy. By 2025, ESG assets will represent "more than a third of the $140.5 trillion in projected total assets under management."[5]

However, despite considerable growth in recent years, ESG assets are also marred by widespread allegations of 'greenwashing', or the provision of misleading information on environmental credentials. The lack of regulation combined with a high demand for ESG products led to a

myriad of sustainable initiatives, standards, principles, products and ratings. The SustainAbility Institute, a consultancy specialised in sustainable finance, has counted over 600 ESG ratings and rankings,[6] while the Organisation for Economic Co-operation and Development and the UN Development Programme have identified over 185 sustainable financing initiatives.[7]

As a result, the sustainable finance ecosystem has grown in not only size but also complexity.[8] Investors increasingly struggle to navigate the rapidly evolving landscape and voice concerns about widespread greenwashing. Comparable ESG data is difficult to obtain, and companies are free to cherry-pick green investment standards. The largest ESG funds, for example, continue to invest in fossil fuel production.[9] Asset managers complain about the lack of credibility in how the leading audit firms assess climate risks.[10] Several contradictions remain to be addressed.

After years of inconsistent ESG reporting, regulatory efforts to establish transparent and comparable sustainable finance standards are gaining momentum at national, regional and international levels. Mandatory ESG disclosures and taxonomies are the instruments of choice across many jurisdictions.

THE REGIONAL, EU APPROACH

The sustainable finance policies, standards and regulations have advanced the most in the EU. In order to mobilise more investments for the European Green Deal, the EU institutions have been exploring innovative ways to integrate sustainability into its financial market regulation and governance. Approved in 2020, the Green Deal is a set of ambitious policy initiatives aimed at transforming "the EU into a modern, resource-efficient and competitive economy, ensuring no net emissions of greenhouse gases by 2050, economic growth decoupled from resource use, [and] no person and no place left behind".[11]

An embodiment of the EU ambition is the EU-wide classification system, the EU taxonomy for sustainable activities. It lies at the core of the EU's sustainable finance strategy, alongside the Sustainable Finance Disclosure Regulation 2019/2088 (SFDR) and the proposal for a Corporate Sustainability Reporting Directive (CSRD). The taxonomy clarifies which economic activities are defined as environmentally sustainable. Compared to other existing tools, the taxonomy is unique in its level of depth. By providing transparency and imposing disclosure obligations on a broad range of market participants, EU policymakers aim to direct investment flows towards sustainable projects and businesses. Meanwhile, the two regulations build on the taxonomy by imposing reporting obligations on large companies (CSRD) and manufacturers of financial products and financial advisers (SFDR).

The SFDR came into force in March 2021 and regulates product and service-level disclosures. It obliges manufacturers of financial products and financial advisers to disclose how sustainability factors are integrated into their investment processes and financial products.[12] A single rulebook for the SFDR and taxonomy disclosures was proposed by European Supervisory Authorities in October 2021, but its application is postponed until 1 January 2023.[13]

The CSRD proposal regulates entity-level disclosures. By targeting all large and listed companies in the EU, it expands the number of companies obliged to disclose sustainability information from roughly 11,000 to 50,000.[14] It also foresees the adoption of European Sustainability Reporting Standards (ESRS), currently being developed by the European Financial Reporting Advisory Group (EFRAG). The latter released exposure drafts for ESRS in April 2022, and the public consultation is open till 8 August 2022.

The EU taxonomy for sustainable activities is unique in its level of detail and depth.

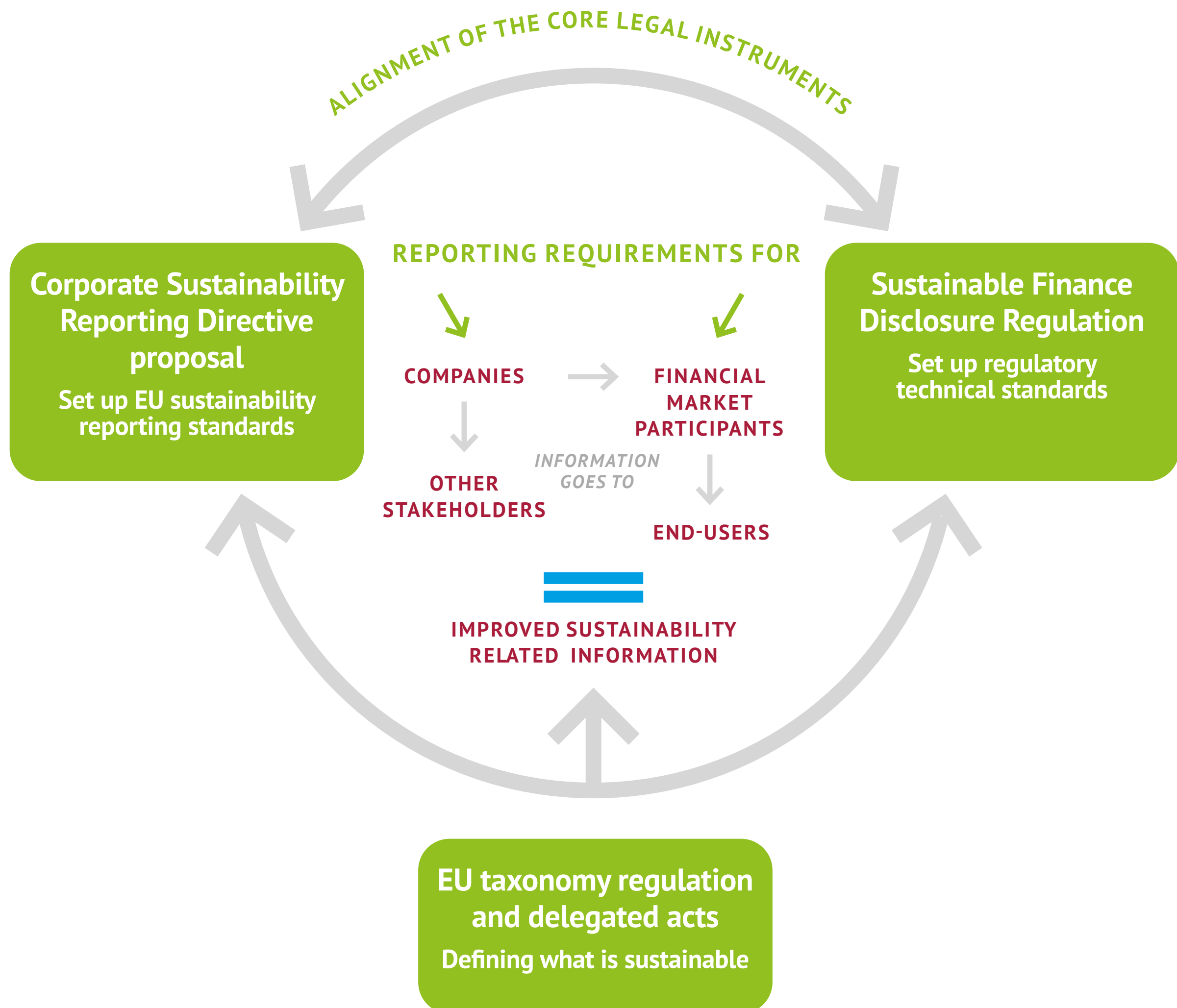
The EU taxonomy is unique in its level of detail and depth. It is often described by the European Commission as the world's "first-ever 'green list'".[15] In a similar vein, *The Economist* writes that this taxonomy could become "the global gold standard" thanks to its "degree of detail and stringency".[16] The taxonomy establishes six environmental objectives:[17]

1) climate change mitigation;
2) climate change adaptation;
3) the sustainable use and protection of water and marine resources;
4) the transition to a circular economy;
5) pollution prevention and control; and
6) the protection and restoration of biodiversity and ecosystems.

EU legislators have completed their work on the first two objectives. The technical screening criteria have been applied from 1 January 2022. On 2 February 2022, the European Commission approved, in principle, a Complementary Climate Delegated Act (CCDA), which includes specific gas and nuclear energy activities. It was also submitted for scrutiny to the European Parliament and Council.

Fig. 1

THE EU'S SUSTAINABILITY DISCLOSURE REGIME



The work on the remaining four objectives is ongoing. The EU Platform on Sustainable Finance (PSF) presented its recommendations for these objectives in March 2022.[18] The relevant delegated act is forthcoming.

But what *is* sustainable? The roles of science and politics

Determining which economic activities are 'green' in the EU taxonomy came with two main challenges. First, EU policymakers had to find a way to effectively align the complex scientific knowledge on climate change with financial matters. The European Commission has always described the taxonomy as "a robust, science-based transparency tool".[19] As such, the Commission created the Technical Expert Group on sustainable finance, and later the PSF, a permanent advisory advising it "on the technical screening criteria for the EU taxonomy".[20]

The second challenge stemmed from EU member states' conflicting interests. The labelling of green economic activities will impact the future direction of capital flows. The possibility of including individual economic activities in the taxonomy thus quickly triggered a debate between the member states. Disputes emerged about the climate benefits of bioenergy, forestry, agriculture, gas and nuclear energy, among others.

In particular, the controversy about including fossil gas and nuclear energy in the taxonomy follows a long-term disagreement within Europe around the two sectors' role in the clean energy transition. Germany and Eastern European countries support the inclusion of natural gas as a transition fuel in the taxonomy and threatened to veto the EU Council proposal. In the case of nuclear energy, France, Bulgaria, Croatia, Czechia, Finland, Hungary, Poland, Romania and Slovakia support its

inclusion; Germany, Luxembourg, Austria, Portugal and Denmark oppose it strongly.

On 31 December 2021, the European Commission proposed criteria for including specific nuclear power- and gas-related activities in the taxonomy. Although some welcomed the draft text of the CCDA, heavy critique followed from multiple organisations, including the World Wildlife Fund, the European Consumer Organisation and the European Federation for Transport and Environment.[21] Notably, the Chair of the PSF described the decision in his first reaction as an "evident departure from a science-based approach to determining when transitioning energy activities do or do not make a substantial contribution to climate change mitigation targets".[22] The PSF response to the draft text, published on 21 January 2022, argued that the proposed technical screening criteria "are not suitable for green, sustainable finance products or instruments in the market today."[23]

Nevertheless, the European Commission approved, in principle, the CCDA on 2 February 2022 and submitted it to the European Parliament and the Council for scrutiny. As neither of the co-legislators objected during the scrutiny period lasting until 11 July 2022, the delegated act will enter into force on 1 January 2023.

Announced at the beginning of the year, the Commission's proposal appeared to be a political compromise at the time. However, many observers still criticised the inclusion of fossil gas and nuclear energy, arguing that it risks undermining the integrity and credibility of the new green classification system as a whole.

The European Parliament's Committee on Economic and Monetary Affairs and the Committee on Environment, Public Health and Food Safety endorsed some of these arguments. The Members of the European Parliament (MEPs) in the two committees objected to the inclusion of nuclear energy and natural gas, arguing that the standards proposed by the Commission "do not respect the criteria for environmentally sustainable economic activities".[24] Furthermore, the MEPs criticised the Commission for not conducting public consultation or a dedicated impact assessment, or consulting the Parliament.[25] In a plenary vote on 7 July 2022, the European Parliament voted not to object to the inclusion of gas and nuclear activities in the taxonomy. The outcome of the vote was criticised by opponents as an act of greenwashing. In response, Austria and Luxembourg announced that they plan to challenge the CCDA before the European Court of Justice (ECJ).[26]

Other issues

The EU's sustainable finance strategy has also been criticised for its fast pace of regulatory developments. Financial market participants and companies were given limited time to interpret complex and lengthy regulatory obligations. Furthermore, delays in the adoption of individual legislative instruments led to regulatory timeline misalignments.[27] A case in point is the obligation of asset managers to report, under the SFDR, on the "EU Taxonomy that is not complete, using company Taxonomy-alignment data that does not exist."[28]

In addition, some stakeholders foresee high compliance costs caused by the wrong "calibration" of individual tools. The International Capital Market Association published a report that raised concerns about the level of complexity and granularity of the EU taxonomy, especially when applying technical screening criteria in non-EU jurisdictions. It argues that the right balance must be found to improve the usability of the classification system for the financial and corporate sectors.[29]

Policymakers should not underestimate the complexity of simultaneously rolling out and updating several interlinked legislative tools.

Some, all or a combination of these issues may – at least temporarily – hinder the effectiveness of the evolving sustainable finance strategy. As the EU sustainable finance toolbox evolves, EU policymakers should thoroughly assess and address these concerns. Policymakers elsewhere should not underestimate the complexity of simultaneously rolling out and updating several interlinked legislative tools.

SELECTED NATIONAL APPROACHES TARGETING GREENWASHING OUTSIDE THE EU

Besides the EU regulatory initiative, green standards are also being developed elsewhere, as national policymakers around the globe step up their activities. Sustainable finance taxonomies, strategies and climate-related disclosures are at various stages of development in the US, UK, China, France, the Netherlands and Japan, to name a few.[30]

The UK approach to greening financial systems was outlined in the 2019 Green Finance Strategy and further advanced in the 2021 Roadmap to Sustainable Investing. Both documents build on the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD).[31] These voluntary recommendations were released in 2017, and 8 jurisdictions (including the UK, EU, Switzerland and Japan) announced TCFD-aligned reporting requirements.[32] The UK's Financial Conduct Authority from 2020 had gradually introduced rules for several types of firms to disclose against the recommendations of the TCFD. It also commenced in 2021 its work on Sustainability Disclosure Requirements, which will continue to implement the TCFD recommendations together with forthcoming UK taxonomy disclosures.[33]

The US SEC published a landmark proposal for Enhancement and Standardization of Climate-Related Disclosures in March 2022 and welcomed comments until 17 June 2022.[34] In a similar vein to the EFRAG's ESRS currently under public consultation, the US SEC's proposal aims to standardise the currently fragmented climate-related disclosures.

As both financial markets and climate change operate at the global level, global coordination will be necessary to realise the full potential of sustainable finance.

Although these evolving regulatory developments have enormous potential to channel finance towards sustainable economic activities, they also carry the risk of challenging data comparability at the international level. Comparative studies of national and regional approaches identify differences across the main building blocks of ESG disclosure: content, voluntary versus mandatory character, materiality, scope, modalities of verification and reporting standards.[35] As both financial markets and climate change operate at the global level, global coordination will be necessary to realise the full potential of sustainable finance.

GLOBAL BASELINE STANDARDS SEARCHING FOR A GLOBAL COMPROMISE

Efforts to establish transparent and comparable sustainable finance standards at the global level are gaining momentum, too. Next to existing initiatives like the TCFD or the Global Reporting Initiative (GRI), the international community welcomed the creation of the ISSB at the COP26 in November 2021. The following paragraphs focus on the ISSB's efforts to set up a global baseline of sustainability-related disclosure standards and identify the potential main points of friction with national and regional initiatives. Described as a "giant leap" forward and "the biggest change in corporate reporting since the 1930s",[36] the new global baseline rules could bring much-needed clarity to the ESG arena and simplify reporting for globally operating entities. The ISSB released the first two exposure drafts on climate and general sustainability-related financial disclosures (i.e. IFRS S1 and S2) in March 2022. Comments can be submitted until 29 July 2022.[37]

However, the search for a global compromise will likely generate several challenges. The EU's experience with its taxonomy and the tension around natural gas and nuclear energy illustrates the difficulties likely to emerge when national interests compete. Such risks are only exacerbated further at the global level, where different national interests are practically a given.

In particular, different definitions of *materiality* were subjected to close scrutiny. The UK,[38] the GRI and the EU have decided or are considering to adopt the the 'double materiality' perspective. First introduced by the European Commission in the Non-Financial Reporting Directive 2014/95/EU in 2014, double materiality requires companies "to report about how sustainability issues affect their business and about their own impact on people and the environment."[39]

However, the International Financial Reporting Standards Foundation (which established the ISSB) has traditionally focused on satisfying the information needs of investors. In a similar vein, US SEC's proposal is grounded in the existing securities law materiality concept focused on investors' information needs.[40]

Unsurprisingly, the ISSB's draft standards and the US SEC's proposal will consider environmental and societal impacts only as long as they impact enterprise value. While some observers describe the former's approach as 'financial materiality', the ISSB refers to "dynamic materiality",[41] arguing that what matters for investors may change over time.

By accounting for impacts on people and the environment, the double materiality approach is better suited to addressing the long-term risks of climate change. On the other hand, the ISSB's pragmatic focus on investor-focused materiality makes it more likely to be accepted at the global level.

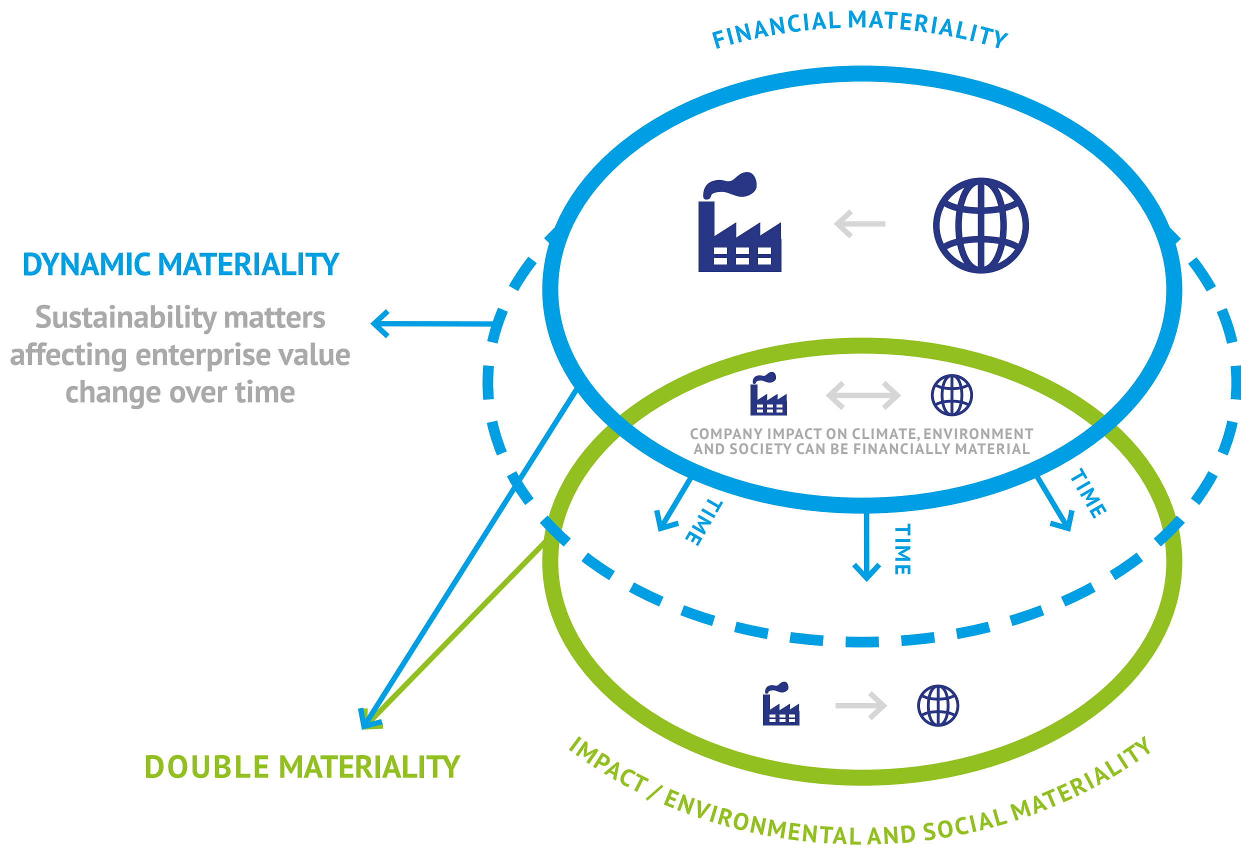
From the perspective of market participants, ensuring the interoperability and alignment of the ISSB's disclosure standards with national and regional approaches will be crucial. Depending on the level of alignment between the global standards on one hand and national or regional standards on the other, a market participant could face multiple scenarios. Ideally, the ISSB and other jurisdictions would fully align their requirements. The 'building block' approach would allow for the development of a global baseline that can operate along with more ambitious standards effectively, regardless of whether they stem from national and regional jurisdictions or international initiatives (e.g. GRI). Jurisdictions would recognise disclosures made pursuant to the ISSB's disclosure standards elsewhere or adopt them voluntarily.

If a global compromise cannot be reached because of timeline misalignment and/or other reasons, the level of alignment between the different standards would have considerable implications for market participants. In order to minimise the burden of complying with the different regulatory requirements, national, regional and global standard-setters should develop approaches that use the same terminology wherever possible and are mostly aligned. This would mean minimal adjustments when reporting under the different standards.

In the worst-case scenario, the global standards would require entirely different disclosures for national or regional jurisdictions. When reporting under the different

Fig. 2

DOUBLE, DYNAMIC AND FINANCIAL MATERIALITY



standards, there would be only a few overlaps, and market participants would face a significant burden to comply with the different regulatory requirements.

The US SEC, EFRAG and ISSB have all recently published their draft proposals for sustainability-related financial disclosure rules. It is positive that all three proposals have a common starting point by building on the TCFD framework. However, they differ in scope, level of prescriptiveness, materiality concepts, metrics and targets.[42] Decision-makers in all three institutions recognise that alignment will be essential to avoid creating competing standards. The EFRAG published a reconciliation table mapping differences and similarities between the ESRS and the ISSB's IFRS S1 and S2 exposure drafts.[43] Furthermore, following a recommendation of the International Organization of Securities Commissions,[44] the ISSB established a working group composed of representatives from the European Commission, the EFRAG, China, Japan, the US and the UK in April 2022.[45] The group aims to facilitate an intensive dialogue on alignment in a formalised setting.

Recommendations

To address greenwashing, any attempt to develop an effective sustainable finance ecosystem must start with improving the availability and comparability of non-financial ESG data. This Discussion Paper studies the ongoing regulatory efforts to achieve this goal.

The EU's sustainable finance strategy is one of the most ambitious and advanced approaches and therefore offers a number of lessons learned for other jurisdictions. On the basis of the EU experience, the following recommendations for national, other regional and global initiatives can be made.

The EU's sustainable finance strategy is one of the most ambitious and advanced approaches and therefore offers a number of lessons learned for other jurisdictions.

The role of science and politics: Policymakers should facilitate a transparent process underpinned by scientific expertise. The EU taxonomy has been presented as a "science-based transparency tool for companies and investors."[46] Faced with the challenge of reconciling the complex science of climate change with financial matters, the European Commission engaged in a dialogue on what exactly is sustainable by setting up the PSF.

However, the Commission also had to weigh the EU member states' positions in its decision-making. In particular, the discussion about the role of natural gas and nuclear energy in the transition toward climate neutrality became highly politically charged. In an attempt to find a compromise, the Commission chose to go against the PSF's advice and proposed including certain nuclear energy- and gas-related activities in the taxonomy. This triggered heavy critique that the taxonomy is departing from its science-based spirit. The debate continued in the European Parliament. The MEPs sitting on the Committee on Economic and Monetary Affairs and the Committee on the Environment, Public Health and Safety called into question the transparency of the process and objected to the Commission's decision. However, in a plenary vote on 7 July 2022, the Parliament voted not to object to the inclusion of gas- and nuclear energy-related activities in the taxonomy. The CCDA is expected to be challenged by Austria and Luxembourg before the ECJ.

The development of other green taxonomies is likely to pose similar challenges for policymakers elsewhere. While it is necessary to recognise that the transition to a climate-neutral economy will not be achieved without political compromises, the EU experience shows that the roles of political interest and science must be carefully balanced and addressed transparently.

Step-by-step approach: The adoption and entry into force of interlinked legislative instruments should follow a logical, step-by-step process. All involved participants, from the legislators and regulatory agencies to the individual businesses, will have to undergo a steep learning curve since sustainable finance combines elements of climate science with financial regulatory governance. Stakeholders should recognise that significant capacity-building efforts will have to accompany the roll-out of new sustainable finance policies. A good example of such efforts is the European Securities and Markets Authority's plan to facilitate exchanges between national authorities and develop a training plan.[47]

Stakeholders should recognise that significant capacity-building efforts will have to accompany the roll-out of new sustainable finance policies.

Double materiality: To adequately access the financial system's capacity to support climate action and redirect investment where necessary, double materiality approaches should be promoted wherever possible. Such approaches are particularly relevant as they provide information about the impact of corporate activities on climate change and their contribution to the net-zero transition. Jurisdictions adopting double materiality should continue their engagement in international fora to advocate for the inclusion of double materiality in ESG disclosure standards. At the same time, to enable a global compromise on baseline standards, a certain level of pragmatism will be unavoidable. Joint efforts to make different jurisdictional approaches interoperable should be a priority.

Interoperability and alignment: The fast-evolving regulatory interventions at the national level can improve the transparency and reduce the complexity of the ESG ecosystem. At the same time, in the absence of international cooperation, the emergence of competing incompatible global, regional and national ESG disclosure standards could mean more transaction costs and complexity for businesses.

The standards currently being developed by the ISSB, EFRAG and US SEC's climate disclosure rules will all be built on the TCFD framework. While reliance on a

common existing framework like the TCFD is a positive starting point, the drafts released by the US SEC, EFRAG and ISSB must be aligned further to avoid creating competing standards. Furthermore, efforts must be maximised to reach a compromise on global baseline standards which effectively implement a 'building block' approach. As such, the next step should be to maximise the working group's efforts and the future Sustainability Standards Advisory Forum to ensure compatibility between global standards with national and regional initiatives.

Conclusion: The prospects for sustainable finance

Financial markets worldwide carry the potential to be a part of the global solution to transitioning to climate neutrality. The rising demand for ESG-aligned products and global regulatory efforts to reorient capital flows towards sustainable projects, products and services give hope. However, ESG markets are still too underregulated. Comparable and reliable ESG data is difficult to obtain. Common definitions of underlying concepts, like greenwashing, still need to be developed.

ESG markets are still too underregulated. Comparable and reliable ESG data is difficult to obtain. Common definitions of underlying concepts, like greenwashing, still need to be developed.

International cooperation is of crucial importance. Regulatory races at sub-international levels could, in the absence of international cooperation, prevent the global ESG ecosystem from achieving its full potential. Divergent national, regional and global ESG disclosure standards mean more costs and complexity for businesses. In order to mobilise the investment volumes necessary to support the global transition to climate neutrality, global cooperation will be necessary.

There are limits to how much sustainable finance can do alone. While disclosure is essential, it will not stimulate sufficient investment volumes for financing the climate transition alone. Improving the availability and comparability of ESG data will alleviate the risk of greenwashing and deliver more investment where needed. However, sustainable finance will always be a mere tool, albeit a critical one. Broader enabling policies will still be needed to nudge economic actors to stimulate demand for ESG assets and create sustainable project pipelines. Emission trading schemes; carbon and environmental taxes; other fiscal policy instruments; and broader climate, energy and transport policies can help drive the green transition and be powerful in directing investors towards sustainable economic activities. Policy coherence will be crucial for exploiting available synergies to their fullest potential.

1. *Climate Action Tracker*, "Temperatures: Addressing Global Warming" (accessed 24 June 2022).
2. Krishnan, Mekala; Hamid Samandari; Jonathan Woetzel; Sven Smit; Daniel Pacthod; Dickon Pinner; Tomas Nauclér; Humayan Tai; Annabel Farr; Weige Wu; and Danielle Imperato (2022), "The Net-Zero Transition: What it would cost, what it could bring", McKinsey & Company, p.5.
3. Mirchandani, Bhakti, "The Biggest Change In Corporate Reporting Since The 1930s: How To Read IFRS Prototype Sustainability And Climate Standards", *Forbes*, 04 November 2022.
4. Petraki, Anastasia, "The ESG regulation race is on", Schroders, 06 January 2022.
5. Diab, Adeline and Gina Martin Adams, "ESG assets may hit $53 trillion by 2025, a third of global AUM", *Bloomberg Professional Services*, 23 February 2021.
6. Wong, Christina and Erika Petroy (2020), "Rate the Raters 2020: Investor Survey and Interview Results", SustainAbility Institute.
7. Organisation for Economic Co-operation and Development and UN Development Programme (2020), "Framework for SDG Aligned Finance", p.9.
8. *Ibid.*
9. *The Economist*, "Sustainable Finance Is Rife with Greenwash. Time for More Disclosure", 22 May 2021.
10. Tett, Gillian, "The Green Transition May Depend on Auditors", *Financial Times*, 04 November 2021.
11. *European Commission*, "A European Green Deal" (accessed 24 June 2022).
12. *European Commission*, "Sustainability-Related Disclosure in the Financial Services Sector" (accessed 12 March 2022).
13. Berrigan, John (2021), Letter: Information Regarding Regulatory Technical Standards under the Sustainable Finance Disclosure Regulation 2019/2088, European Commission.
14. *European Parliament*, "Corporate Sustainability Reporting Directive (CSRD)" (accessed 12 March 2022).
15. European Commission, Questions and Answers: political agreement on an EU-wide classification system for sustainable investments (Taxonomy), 18 December 2019.
16. *The Economist*, "The EU's green-investing 'taxonomy' could go global", 08 January 2022.
17. *European Commission*, EU taxonomy for sustainable activities (accessed 24 June 2022).
18. See EU Platform on Sustainable Finance (2022a), Platform on Sustainable Finance: Technical Working Group. Part A: Methodological Report, European Commission.
19. European Commission, Sustainable Finance and EU Taxonomy: Commission takes further steps to channel money towards sustainable activities, Brussels, 21 April 2021a.
20. *European Commission*, "Platform on Sustainable Finance" (accessed 06 June 2022).
21. World Wildlife Fund, "Five Reasons To Oppose The Inclusion Of Gas And Nuclear Power In The EU Taxonomy", 27 May 2022; European Consumer Organisation, "EU Plans to Greenwash Nuclear and Fossil Gas Will Prevent Consumers from Investing Sustainably", 02 February 2022; Khan, Mehreen, "Brussels Faces Backlash over Delay to Decision on Whether Gas Is Green", *Financial Times*, 21 April 2021.
22. Fabian, Nathan, "Below Is My Statement as Chair of the Platform on #SustainableFinanceEU on the Complementary Delegated Act for #EUTaxonomy", *Twitter*, @nathanafabian, 03 February 2022.
23. Platform on Sustainable Finance (2022b), Response to Complementary Delegated Act, European Commission, p.6.
24. European Parliament, Taxonomy: MEPs Object to Commission's plan to include gas and nuclear activities, 14 June 2022.
25. European Parliament Committee on Economic and Monetary Affairs and Committee on the Environment, Public Health and Food Safety (2022), DRAFT MOTION FOR A RESOLUTION pursuant to Rule 111(3) of the Rules of Procedure on Commission delegated regulation of 9 March 2022 amending Delegated Regulation (EU) 2021/2139 as regards economic activities in certain energy sectors and Delegated Regulation (EU) 2021/2178 as regards specific public disclosures for those economic activities, C(2022)00631 – 2022/2594(DEA).
26. Noyan, Oliver, "Austria to challenge taxonomy in EU court", *EURACTIV*, 07 July 2022.
27. Saddighzadeh, Rokhsana; Brad Foster; and Greg Van Droogenbroeck, "Solving for EU ESG Taxonomy Data Challenges", *Bloomberg Professional Services*, 01 December 2021.
28. Petraki (2022), *op.cit.*
29. Pfaff, Nicholas and Ozgur Altun (2022), "Ensuring the usability of the EU Taxonomy", Zurich: International Capital Market Association.
30. See Organisation for Economic Co-operation and Development (2020), *Developing Sustainable Finance Definitions and Taxonomies*.
31. See UK (2019), "Green Finance Strategy: Transforming Finance for a Greener Future", London.
32. See Task Force on Climate-related Financial Disclosures (2021), "2021 Status Report", p.4.
33. Financial Conduct Authority (2021), "Sustainability Disclosure Requirements (SDR) and investment labels", London.
34. US Securities and Exchange Commission, "SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors", Washington DC, 21 March 2021.
35. International Platform on Sustainable Finance (2021), "State and Trends of ESG Disclosure Policy Measures across IPSF Jurisdictions, Brazil, and the US".
36. Mirchandani (2022), *op.cit.*
37. *International Financial Reporting Standards Foundation*, "Exposure Draft and Comment Letters: General Sustainability-Related Disclosures" (accessed 03 July 2022).
38. The UK's Financial Conduct Authority conducted a consultation on Sustainability Disclosure Requirements, which are currently being developed. Double materiality was included in the consultation document.
39. European Commission, Questions and Answers: Corporate Sustainability Reporting Directive proposal, Brussels, 21 April 2021b.
40. PricewaterhouseCoopers, "The SEC Wants Me to Disclose What? The SEC's Climate Disclosure Proposal", 07 April 2022.
41. International Financial Reporting Standards Foundation (2021), "IFRS Foundation Trustees' Feedback Statement on proposed amendments to the IFRS Foundation's Constitution", London.
42. Haddon, Matt; Robert LaCount; Justin Nelson; Kevin Stephen; Anissa Vasquez; and Kristina Wyatt (2022), "The Evolution of Sustainability Disclosure: Comparing the SEC, ESRS, and ISSB Proposal", The SustainAbility Institute and Persefoni.
43. Project Task Force on European sustainability reporting standards (2022), "Draft European Sustainability Reporting Standards: Appendix V – IFRS Sustainability Standards and ESRS reconciliation table", European Financial Reporting Advisory Group.
44. See International Organization of Securities Commission (2021), "Report on Sustainability-related Issuer Disclosures: Final Report".
45. International Financial Reporting Standards Foundation, "ISSB establishes working group to enhance compatibility between global baseline and jurisdictional initiatives", London, 27 April 2022.
46. European Commission (2021a), *op.cit.*
47. See *European Securities and Markets Authority*, "Sustainable Finance Roadmap 2022-2024" (accessed 20 March 2022).

NOTES

NOTES

The **European Policy Centre** is an independent, not-for-profit think tank dedicated to fostering European integration through analysis and debate, supporting and challenging European decison-makers at all levels to make informed decisions based on sound evidence and analysis, and providing a platform for engaging partners, stakeholders and citizens in EU policymaking and in the debate about the future of Europe.

The **Sustainable Prosperity for Europe** programme explores the foundations and drivers for achieving an environmentally sustainable and competitive European economy. While the climate crisis is a complex challenge to be addressed, non-action is not an option. Prospering within the planetary boundaries requires rethinking the existing take-make-dispose economic model, reducing pollution and being smarter with the resources we have.

The Paris Agreement and the Sustainable Development Agenda provide a direction for travel. The programme engages in a debate on the needed measures to achieve a fair transition to an environmentally sustainable economy and society. It focuses on areas where working together across the European Union can bring significant benefits to the member states, citizens and businesses, and ensure sustainable prosperity within the limits of this planet.

With the strategic support of