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Are sustainable finance policies evidence-based?

An analysis of whether the EU's
procedural framework for sustainable
finance policy making is fit for
purpose

August 2021

About 1in1000

1in1000 is a new research program by 2° Investing Initiative (2DII) that brings together new & existing research projects on long-termism, climate change, and (inter-)connected future risks for financial markets, the economy, and society. Its objective is to develop evidence, design tools, and build capacity to help financial institutions and supervisors to mitigate and adapt to future risks and challenges. The program focuses on climate change and the universe of risks and challenges linked to climate change, notably ecosystem service and biodiversity loss, as well as risks from a decline in social cohesion and resilience.

To achieve this objective, 1in1000 focuses on three main areas: i) Long-term metrics; (ii) Risk (management) tools and frameworks; and (iii) Policies & incentives.

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Working globally with offices in Paris, New York, Berlin, London, and Brussels, 2DII coordinates some of the world's largest research projects on sustainable finance. In order to ensure its independence and the intellectual integrity of its work, 2DII has a multi-stakeholder governance and funding structure, with representatives from a diverse array of financial institutions, regulators, policymakers, universities and NGOs.

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FUNDER: This project is part of the International Climate Initiative (IKI). The Federal Ministry for the Environment, Nature Conservation and Nuclear Safety (BMU) supports this initiative on the basis of a decision adopted by the German Bundestag. This report reflects the authors' views only, and the funders are not responsible for any use that may be made of the information it contains.

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Executive Summary

The ex-ante impact assessment is one of the most important tools available to policy makers. It is a critical step to promoting informed decision making and ensuring that the final policy design is optimal for addressing the issue at hand.

In the European Union (EU), the Better Regulation Guidelines and the accompanying Better Regulation Toolbox set out the procedural framework for policy making and establish the impact assessment as a key early step ‘to assess if future legislative or non-legislative EU action is justified and how such action can best be designed to achieve the desired policy objective.’

Where sustainable finance policy relates to an objective of reorienting capital flows, the impact assessment should assess the extent to which the recommended policy option contributes to this objective of reorienting capital flows.

This paper analyses to what extent any assessment of reorienting capital flows has occurred in the European Commission’s financial policy making under the 2018 Action Plan on Financing Sustainable Growth (the SFAP). It reviews the impact assessment conducted for the three main legislative initiatives under the SFAP (namely the Taxonomy Regulation, the Sustainable Finance Disclosure Regulation and the Low Carbon Benchmark Regulation) and analyses the extent to which the impact assessment covers the contribution of the recommended policy options towards the objective of reorienting capital flows.

The paper finds that, despite one of the objectives of the SFAP and the legislative proposals thereunder being to reorient capital flows, the relevant impact assessment report does not contain any thorough assessment of the extent to which these legislative proposals are expected to contribute towards reorienting capital flows.

In this crucial year for sustainable finance policy, with the recent release of a new Sustainable Finance Strategy, the impact assessment process must be improved to ensure that any policy is actually doing what it needs to. EU policymakers do not have a moment to lose and cannot afford any mistakes.

The paper articulates recommendations for improvements which are necessary in the context of financial policy making with an objective to reorient capital flows. We consider that a new guidance tool should be developed for the Better Regulation Toolbox to ensure that the research advances in relation to alignment metrics are integrated into the impact assessment process (Recommendation 1). Further, the Regulatory Scrutiny Board should provide greater scrutiny and oversight of the formulation of the policy objective in the impact assessment and the link to EU overarching climate policies (Recommendation 2). And finally, constituencies involved in sustainable finance policy making must increase their technical expertise in relation to the latest research which is relevant to assessing reorientation of capital flows (Recommendation 3).

2DII will continue to research this area and is planning to release a further paper which will provide impact assessment preparers with further guidance on how to devise the best methodological process for policy impact assessments relating to the sustainable finance agenda.

1

Introduction

Within the context of designing efficient and effective policy and regulation to achieve a specific objective, the *ex-ante impact assessment* is one of the most important tools available to policy makers. The OECD recommends member countries integrate regulatory impact assessments into early stages of the policy process.¹ In the EU, the *Better Regulation Guidelines* set out the procedural framework for policy making and establish impact assessments as a key early step 'to assess if future legislative or non-legislative EU action is justified and how such action can best be designed to achieve the desired policy objective.'²

The EU's 2018 *Action Plan on Financing Sustainable Growth*³ (the **SFAP**) is a package of financial policies intended to (among other things) help implement the Paris Agreement in the EU. One of the SFAP core objectives relates to 'reorient[ing] capital flows towards sustainable investment in order to achieve sustainable and inclusive growth.'⁴ This implies that the impact assessment for relevant policy files under the SFAP should assess the extent to which the recommended policy option contributes to this objective of reorienting capital flows.

This paper analyses the extent to which any assessment of reorienting capital flows has occurred in the Commission's financial policy making under the SFAP.

- Section 2 presents the procedural framework which applies to EU policy making as articulated in the Better Regulation Guidelines and focusses on the requirements which have been established for the impact assessment.
- Section 3 reviews the impact assessment conducted for the three main legislative initiatives under the SFAP.⁵ It then analyses the extent to which the impact assessment covers the contribution of the recommended policy options towards the objective of reorienting capital flows.
- Section 4 articulates recommendations for improvements to the Better Regulation Guidelines and wider policy making framework which are necessary in the context of financial policies which have an objective of reorienting capital flows.
- Section 5 concludes by emphasizing that improvements in this area are imperative in the context of the new raft of policy files which accompany the Sustainable Finance Strategy published in July 2021.

The focus of this paper is on the methodology which is apparent in the Commission's policy making in this area and therefore does not cover any wider analysis in relation to the political decision making or constitutional and administrative procedures which accompany these political decisions. Neither indeed does this paper focus on broader aspects of the Better Regulation Guidelines which do not relate to ex ante impact assessments.

2DII will continue to research this area and respond to the gaps identified in this present paper. We are planning to suggest new guidance to address the specific challenges involved with designing effective sustainable finance policies.

¹ OECD, 2019, "Regulatory impact assessment across the European Union" in Better Regulation Practices across the European Union. p.70

² SWD (2017) 350

³ COM (2018) 97

⁴ COM (2018) 97 p.2

⁵ Namely the Taxonomy Regulation (Regulation (EU) 2020/852), the Sustainable Finance Disclosure Regulation (Regulation (EU) 2019/2088) and the Low Carbon Benchmark Regulation (Regulation (EU) 2019/2089). Note that impact assessments have been carried out in relation to other policy measures articulated in the SFAP, however for the purpose of this paper we focus on the impact assessments associated with the main legislative proposals.

2

European Union procedural framework for policy making

2.1 The concept and framework for “better regulation” in the European Union

“Better regulation” means designing EU policies and laws so that they achieve their objective at minimum cost.⁶ All EU institutions have committed to this principle.⁷ It establishes several ‘objectives, tools and procedures to make sure that the EU has the best policy possible.’⁸

Better regulation is not about regulating or deregulating, but rather ensuring that ‘political decisions are prepared in an open, transparent manner, informed by the best available evidence and backed by the comprehensive involvement of stakeholders’⁹ while respecting the subsidiarity and proportionality principles.¹⁰ Therefore, the concept is related to policy optimisation and procedural efficacy, but also provides a means to navigate the hierarchy between the supranational position of the EU and the jurisdiction of national governments.

The principle of better regulation is operationalised through the Better Regulation Guidelines¹¹ (the **Guidelines**) together with the associated Better Regulation Toolbox (the **Toolbox**).¹² These explain how better regulation should be applied in the daily practices of Commission officials preparing new initiatives and proposals or managing existing policies and legislation. They are intended to be applied in a proportionate manner and exceptions are possible if validated externally.¹³

The Guidelines themselves set out mandatory requirements for each step of the policy cycle. Each step has a chapter of the Guidelines devoted to it and are defined as:

- Planning
- Ex ante impact assessment
- Implementation
- Monitoring
- Evaluation & fitness checks
- Stakeholder consultation

The Toolbox sets out further, non-mandatory guidance on the principles of better regulation and implementing the Guidelines in specific contexts. Tools cover all steps of the policy cycle. For instance, Tools #8 to #18 set out further guidance on ex ante impact assessment and Tools #19 to #35 set out specific guidance for both ex ante impact assessments and evaluation & fitness checks.

In this paper, we focus on the requirements associated with the ex ante impact assessment as a critical step to ensure efficient and optimal policy design.

⁶ SWD (2017) 350

⁷ Interinstitutional Agreement between the European Parliament, the Council of the European Union and the European Commission on Better Law-Making, 2016

⁸ SWD (2017) 350 p.5

⁹ SWD (2017) 350 p.4

¹⁰ Interestingly, it is also claimed that ‘Better regulation also provides the means to mainstream sustainable development into the Union’s policies.’ (SWD (2017) 350 p.4)

¹¹ SWD (2017) 350

¹² Available at: https://ec.europa.eu/info/law/law-making-process/planning-and-proposing-law/better-regulation-why-and-how/better-regulation-guidelines-and-toolbox/better-regulation-toolbox_en

¹³ Note also that a special regime may apply for certain policy matters (e.g. Commission proposals for a Council decision to implement social partners’ agreements under Article 155 TFEU) (SWD (2017) 350 p.3)

2.2 Ex ante impact assessments as a tool for better regulation

An ex ante impact assessment (IA) is carried out by the Directorate General(s) leading the policy initiative ‘to assess if future legislative or non-legislative EU action is justified and how such action can best be designed to achieve the desired policy objective.’¹⁴ According to the Guidelines, an IA should begin as early as possible in the policy development process (subject to political validation requirements) and is required for all Commission initiatives that are likely to ‘have significant economic, environmental or social impacts.’¹⁵

The process of carrying out an IA requires collecting and analysing evidence to support policymaking. The IA should ascertain the problem (together with its underlying causes) to assess whether EU action is needed. It should evaluate the advantages and disadvantages of a range of policy options which could tackle the problem and present the impacts of those options in terms of who will be affected by them and how.¹⁶

The Guidelines recognise that due to the different areas of EU policy making, the accompanying IAs will be similarly variable. However, all IAs must answer a set of key questions:

1. *What is the problem and why is it a problem?*
2. *Why should the EU act?*
3. *What should be achieved?*
4. *What are the various options to achieve the objectives?*
5. *What are their economic, social and environmental impacts and who will be affected?*
6. *How do the different options compare (effectiveness, efficiency and coherence)?*
7. *How will the monitoring and subsequent retrospective evaluation be organised?*¹⁷

The IA report is the “write-up” of the process that has been followed and the results that have been obtained from it. The draft IA report must be presented to the Regulatory Scrutiny Board¹⁸ and a positive opinion is required before further policy making activities can continue. The Guidelines stipulate various requirements for what must be included in the IA report which includes (for the purposes of the subject matter of this paper) a comparison of the ‘policy options on the basis of their economic, social and environmental impacts (quantified costs and benefits whenever possible).’¹⁹

¹⁴ SWD (2017) 350 p.6

¹⁵ SWD (2017) 350 p.15

¹⁶ SWD (2017) 350

¹⁷ SWD (2017) 350 p.17

¹⁸ The Regulatory Scrutiny Board is an independent body that provides quality control and support for Commission impact assessments and evaluations at early stages of the legislative process. The Board reviews and issues opinions and recommendations on all draft impact assessments, fitness checks, and on major evaluations of existing legislation. The Board also provides cross-cutting advice on better regulation policy to the Commission.

¹⁹ SWD (2017) 350 p.14. Other issues which must be included in the IA report include a description of who will be affected by the initiative and how; impacts on SMEs; impacts on competitiveness.

2.3 Key components of the impact assessment: Question 3 and Question 5

The questions above are designed to ensure that the IA report effectively addresses a wide range of issues – from subsidiarity and proportionality considerations to ongoing monitoring and evaluation processes. The key focus of this paper is on the requirements in relation to the third and fifth questions articulated above which need to be addressed in the IA report:

- *Question 3. What should be achieved?* This section aims at specifying the objectives of the policies and how they articulate with each other and with other EU horizontal objectives.
- *Question 5. What are [the policy options'] economic, social and environmental impacts and who will be affected?* This section aims at providing a thorough assessment of economic, social and environmental impacts of the considered policies.

This paper analyses the extent to which any assessment of reorienting capital flows has occurred in the Commission's financial policy making under the SFAP. And while the Guidelines do permit flexibility in terms of what information is included where in the IA report, these questions are the most relevant to this line of enquiry.

3

Review of impact assessments for Sustainable Finance Action Plan legislative proposals

3.1 Context for EU sustainable finance policy

The SFAP is a collection of policy initiatives, adopted in 2018 by the Commission, designed to reform the financial system. Specifically, the SFAP aims to:

- ‘reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth;
- manage financial risks stemming from climate change, resource depletion, environmental degradation and social issues; and
- foster transparency and long-termism in financial and economic activity.²⁰

The three legislative proposals in the SFAP²¹ are:

- **Taxonomy Regulation:** Proposal for a Regulation of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment.²²
- **Sustainable Finance Disclosure Regulation:** Proposal for a Regulation of the European Parliament and of the Council on disclosures relating to sustainable investments and **sustainability** risks and amending Directive (EU) 2016/2341.²³
- **Low Carbon Benchmark Regulation:** Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 2016/1011 on low carbon benchmarks and positive carbon impact benchmarks.^{24 25}

There is a single IA report covering all these legislative proposals.²⁶ The structure of this IA report largely follows the sequence of questions articulated in Section 2.2 of this paper. The following provides a commentary on the sections of the IA report which cover the third and fifth questions articulated in Section 2.3 of this paper.

²⁰ COM (2018) 97 p.2

²¹ The SFAP identified 10 actions to achieve these three objectives which comprise legislative measures, Level 2 measures (i.e. delegated legislation) and non-legislative measures (such as establishing technical groups or commissioning expert reports).

²² Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088

²³ Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector

²⁴ Regulation (EU) 2019/2089 of the European Parliament and of the Council of 27 November 2019 amending Regulation (EU) 2016/1011 as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks

²⁵ Note however that analysis of the final form of each of these pieces of legislation is not the subject of this paper.

²⁶ SWD (2018) 264

3.2 Analysis of impact assessment report: Question 3 - An imprecise formulation of objectives

The impact assessment report is not clear regarding whether reorientation of capital flows is a core objective of the policies.

3.2.1 Regarding Question 3 – What should be achieved?

Responding to this question requires that the objectives of the policy action should be clearly identified and the level of policy ambition should be articulated together with the criteria for comparing different policy options.²⁷

Clear objectives are necessary for transparency and accountability of policy interventions. In particular, ‘the logical chain between the identified problems, what the initiative aims to achieve and the solutions considered’ together with ‘the relationship between an initiative’s specific goals and any horizontal EU objectives’²⁸ which cut across different policy areas should be clarified. Objectives should be SMART²⁹ and can be split into *general objectives*, relevant to the overall context of EU policy and *specific objectives* which are more operational and which the IA report should focus on.

3.2.2 Analysis of the commentary relevant to Question 3

Reorienting capital flows is explicitly mentioned as one of the general objectives of the policies covered by the IA report.³⁰

However, the policies are assessed not against the general objectives, including the objective of reorienting capital flows, but against a set of three specific objectives (see footnote³¹). Therefore, the contribution of these policies towards reorienting capital flows is made conditional on achieving the specific objectives. Assessing the contribution of these policies towards reorienting capital flows would then have required a robust analysis as to how achieving the specific objectives will assist with achieving the objective of reorienting capital flows. However, such an analysis is absent from the IA report. Indeed, the statement linking the specific objectives and the general objective of reorienting capital flows is as follows:

²⁷ SWD (2017) 350 p.20 Note also that establishing a monitoring and evaluation framework to assess the success of the policy measure which is implemented should also be covered here – but this is outside the scope of this paper.

²⁸ SWD (2017) 350 p.20

²⁹ Specific, Measurable, Achievable, Relevant and Time-Bound

³⁰ SWD (2017) 350 p.34

³¹ ‘Ensure clarity and a coherent approach across sectors and Member States as regards the integration of ESG factors by the relevant entities in their investment/advisory process; Increase transparency towards end-investors by improving ESG-related disclosure requirements; Provide clarity at EU level on what are sustainable economic activities.’ SWD (2018) 264 p.34

*“Increased transparency and reduced search costs [which relate to the specific objectives] will create a more favourable investment environment, where investors can make sustainable investment decisions more easily. As a result, once additional building blocks will be put in place, the proposed initiatives will also help reorient capital flows towards achieving sustainable growth. **The magnitude of the reoriented capital flows will depend on the actual demand for sustainable products among investors operating in this more favourable environment, and on the implementation of the various initiatives supported by this impact assessment.** Therefore, the impact on investment flows will be assessed at a later stage.”³²*

Therefore, the logical chain that has been established is that a more favourable investment environment will help reorient capital flows. But there is no further explanation as to why the policy options will contribute to what is *actually* a more favourable investment environment or the detail of how the more favourable environment will *actually* reorient capital flows. *De facto*, the actual specification of specific and general objectives has the consequence that the assessment of impact is distanced from the objective of reorienting capital flows.

³² SWD (2018) 264 p.34

INFORMATION BOX 1: Reorienting capital flows is a poorly defined concept

This paper analyses the extent to which any assessment of reorienting capital flows has occurred in the Commission's financial policy making under the SFAP.

But even in the absence of this assessment, a more fundamental question relates to precisely what is meant by the concept of *reorienting capital flows*. While the idea makes sense at a conceptual level, there is little further detail about what this means in practice. Feedback from stakeholders consulted during drafting of this paper revealed concerns that there is significant divergence of opinion in relation to these further details. For example, reorientation of capital should be achieved by whom and by when? Or is it problematic that reorientation of capital is conceptualised purely in terms of growth in sustainable investment but with no corresponding reduction in unsustainable investment?

These problems are further compounded by the fact that under the SFAP, reorientation of capital should be *towards sustainable investment*. When considering all the different environmental, social and economic dimensions of sustainability, and indeed within each of these dimensions (e.g. climate change, biodiversity, water etc. for the environmental dimension), this means that the concept of sustainable investment itself is similarly hard to define.

One might hypothesise that this poor definition of what is meant by both *reorienting capital flows* and *towards sustainable investment* has a highly determinative and detrimental effect on any assessment of reorienting capital flows in the IA report. Indeed, this poor definition means the IA report is given an impossible task.

3.3 Analysis of impact assessment report: Question 5 – A weak assessment of the impact on reorientation of capital flows

The assessment of impact of the policies on reorientation of capital relies on non-substantiated assumptions rather than a robust assessment

3.3.1 Regarding Question 5 – What are the impacts of the different policy options and who will be affected?

Responding to this question requires carrying out “a robust assessment [...] of the economic, social and environmental impacts” of each policy option included in the IA. This information will articulate to what extent each policy option tackles the identified problem and meets the policy objective, ‘with what benefits, at what cost, with what implications for different stakeholders, and at what risk of unintended consequences.’³³ The Guidelines stipulate the following steps:

1. Identify all potential impacts of the options

For this step, all possible impacts (positive or negative) are mapped out according to their expected magnitude, likelihood and the affected parties. The impacts should be categorised using the most appropriate method for the initiative at hand and the IA report should be transparent about the methodological choices to assess impacts.

2. Select the significant impacts

The next step is to select which impacts will be subject to deeper assessment. This selection needs to be clearly justified taking account of aspects such as the expected overall magnitude, relevance for stakeholders or the importance for the Commission’s horizontal objectives. The Guidelines stipulate that ‘it is important not to leave out anything that is of relevance for political decision making.’³⁴

3. Assess the most significant impacts

The final step requires all relevant impacts to be assessed. This should be both on a qualitative and a quantitative basis ‘if they are susceptible of being quantitatively estimated through a sound methodology and if the required data exists and can be collected at a proportionate cost.’³⁵ When quantitative analysis is not possible, ‘impacts should be assessed qualitatively and the reasons for not having undertaken quantification explained in the IA report.’³⁶ Moreover, ‘important underlying assumptions will have to be stated [and] the conclusions should rely on available theory and evidence [...] They should acknowledge limits and clearly distinguish between facts, expert opinions and stakeholder views.’³⁷

³³ SWD (2017) 350 p.23

³⁴ SWD (2017) 350 p.25

³⁵ SWD (2017) 350 p.26

³⁶ SWD (2017) 350 p.26

³⁷ SWD (2017) 350 p.26

After these steps have been taken 'there should be a solid understanding of the extent to which each option achieves the objectives, with what benefits and at what costs at the aggregate level and for affected parties.'³⁸ The IA report should then present the results in a way which is accessible to the non-specialist while being clear and transparent about any limitations and risks of unintended consequences.

3.3.2 Analysis of the commentary relevant to Question 5

Economic impacts

The impact on the reorientation of capital flows is mentioned in the assessments of economic impacts as follows.

The IA report claims that '*[b]y providing more clarity on the market on which activities can be considered as environmentally sustainable, fostering the sustainable investment market and mainstreaming sustainability into risk management, **the Commission initiative is expected to contribute to the reorientation of capital flows towards sustainable investments and hence to the objective foster a sustainable economy. The magnitude of the reoriented capital flows will depend on (i) the actual interest for sustainable products among investors operating in this more favourable environment, and (ii) on the implementation of several elements of the various initiatives, which will be impact-assessed at a later stage.***'³⁹

The following table sets out a summary analysis of the IA report presentation of specific economic impacts of each initiative.⁴⁰

³⁸ SWD (2017) 350 p.27

³⁹ SWD (2018) 264 p.105

⁴⁰ The IA report commentary on *Competitiveness and impact on third countries* and *Impact on issuers* is not included as is not relevant to the subject of this paper.

Economic impact of preferred options on integration of ESG factors and disclosure	Various theories of change articulated as to why a clear and coherent approach on integration of ESG factors is desirable but no discussion of the extent to which the preferred option will contribute to reorienting capital flows.
Economic impact of preferred option on taxonomy	<p>Various theories of change articulated as to why identifying sustainable economic activities is desirable.</p> <p>The only discussion of the extent to which the preferred option will contribute to reorienting capital flows is: '<i>... a uniform classification at EU level would already help to determine which activities can be regarded as sustainable and send appropriate signals to economic actors, as it would "translate" EU policy objectives into tangible guidance to identify the relevant projects or investments. It could therefore help orient more capital flows towards sustainable investments.</i>'⁴¹</p>
Economic impact of preferred option on low carbon indices	<p>Various theories of change articulated as to why minimum standards for low carbon benchmarks are desirable.</p> <p>The only discussion of the extent to which the preferred option will contribute to reorienting capital flows is: '<i>By developing common minimum standards for which products can claim to follow a "low carbon" or "2 degree" investment strategy it would also help reduce greenwashing risks, thus ensuring a more effective allocation of funds towards sustainable assets and lower search costs for stakeholders.</i>'⁴²</p>

Environmental impacts

The impact on the reorientation of capital flows is also mentioned in the assessment of environmental impacts of the policies as follows.

The commentary for environmental impact also presents an overall environmental impact of all initiatives and then the specific environmental impact of each single initiative. In terms of the overall impact of the initiatives, the commentary articulates that by mainstreaming and supporting the development of sustainability considerations into an efficient and competitive financial market this is expected to facilitate investments in (more) sustainable projects and assets. The specific environmental impact of each single initiative is articulated as follows.

⁴¹ SWD (2018) 264 p.108

⁴² SWD (2018) 264 p.108

Impact of preferred options on integration of ESG factors and disclosure	<p>The only discussion of the extent to which the preferred option will contribute to reorienting capital flows is: <i>‘Greater clarity on ESG integration and increased transparency will raise ESG awareness among all stakeholders, possibly unlocking capital flows towards environmental investments.</i>⁴³</p> <p>Otherwise, the commentary here refers to furnishing end-investors with adequate information to identify investments which are aligned with their environmental preferences and contributing to enhancing investor confidence regarding “green” claims – but this discussion (although relevant) is not specifically linked to reorienting capital flows.</p>
Impact of preferred option on taxonomy	<p>The only discussion of the extent to which the preferred option will contribute to reorienting capital flows is: <i>‘The first impact of the taxonomy is that it will clarify what is green, which should directly benefit investors and financial market participants. It is then expected to have a series of positive secondary/indirect impacts, depending on the uses made of the taxonomy [...], including a positive environmental impact. By providing clarity on what is ‘green’, an EU taxonomy would facilitate investments in sustainable projects and assets across the EU. This would contribute to the achievement of the EU environmental goals e.g. lowering greenhouse gas emissions in line with the Paris Agreement, and moving to a resource-efficient and circular economy.</i>⁴⁴</p>
Impact of preferred options on low-carbon indices	<p>The only discussion of the extent to which the preferred option will contribute to reorienting capital flows is: <i>‘For this reason, the harmonisation of sound and transparent methodologies based on EU minimum standards for different types of low-carbon indices would provide all types of investors pursuing different types of low-carbon strategies with adequate tools to assess the coherence in terms of suitability between their fund/portfolios and the benchmark and track/measure the performance against a low-carbon benchmark. With a sound methodology to select its underlying assets, an index, can also help in aligning corporate strategies and the economy with climate goals.</i>’</p>

⁴³ SWD (2018) 264 p.109

⁴⁴ SWD (2018) 264 p.110

The Guidelines articulate that a quantitative assessment of the impact should be carried out where possible and proportionate. As set out above, there is no quantitative assessment of the extent to which the policy options contribute to the objective of reorienting capital flows. This is the case for both economic and environmental impacts.

When quantitative analysis is not possible or proportionate, the Guidelines state that qualitative assessment and articulation of the reasons for not having undertaken quantification should be included in the IA report. Based on our analysis of the IA report, there is no explicit recognition of the fact that a quantitative assessment has not taken place, nor articulation of the reasons why such a quantitative assessment is not possible or proportionate.

Furthermore, the qualitative assessment of the degree to which the policy options contribute to reorienting capital flows is structured on the assumption that achieving the specific objectives will lead to achieving this general objective. Indeed, the rationale provided in the above tables explicitly relates the reorientation of capital flows to:

- Specific objective 1: Ensuring clarity and a coherent approach across sectors (e.g. ‘By developing common minimum standards ... it would also help reduce greenwashing risks, thus ensuring a more effective allocation of funds towards sustainable assets’⁴⁵);
- Specific objective 2: Increasing transparency towards end investors (e.g. ‘Greater clarity on ESG integration and increased transparency will raise ESG awareness among all stakeholders, possibly unlocking capital flows towards environmental investments’⁴⁶);
- Specific objective 3: Providing clarity at EU level on what are sustainable economic activities (e.g. ‘a uniform classification at EU level [...] could therefore help orient more capital flows towards sustainable investments’⁴⁷).

Therefore, what qualitative analysis there is at best relates to how the policy options will contribute to achieving the specific objectives. But there is no analysis of how achieving the specific objectives will contribute to the general objective of reorienting capital flows. Theoretical links between achieving the specific objectives and the general objective of reorienting capital flows are not substantiated and the impact assessment remains silent on the underlying assumptions allowing this assertion. There is moreover no explicit recognition of potential limitations of the approach chosen.

⁴⁵ SWD (2018) 264 p.108

⁴⁶ SWD (2018) 264 p.109

⁴⁷ SWD (2018) 264 p.108

INFORMATION BOX 2 – What should the IA report cover in its line of enquiry?

The main thesis of this paper is that overall, there is no analysis in the IA report of how the policy options contribute to the general objective of reorienting capital flows. The IA report incorporates both general objectives and specific objectives for the policy options. And while one of the general objectives relates to reorienting capital flows, the three specific objectives are different. What analysis of environmental and economic impacts there is relates to assessing impacts against the specific objectives. This means that there is no analysis against the general objective of reorienting capital flows (either directly or indirectly through examining how any specific objective might contribute to reorienting capital flows).

2DII will continue to research this area and respond to the gaps identified in this present paper. We are planning to suggest new guidance to address the specific challenges involved with designing effective sustainable finance policies. This will furnish IA preparers with as much information as possible to devise the best methodological process for any IA which relates to reorienting capital flows.

But for the purposes of this present paper, it is worth articulating the types of issues which the IA report should have covered in its line of enquiry. In the context of the assessment of the preferred option on low-carbon indices, responding to the following questions would provide useful analysis of the extent to which this policy option would play its part in contributing towards reorienting capital flows:

- What is the current market size for low carbon indices?
- What growth could be anticipated to this market as a result of the preferred option?
- What growth could be anticipated to this market without any policy action?
- If the preferred option does grow the market, how much capital would be reoriented in practice (e.g. given the overlaps between mainstream and low-carbon benchmarks)?
- What impact would the reorientation of capital triggered by preferred option mean for cost and availability of capital for different types of company?
- What kind of greenhouse gas emissions reductions in the real economy could be potentially triggered?
- What are the potential unintended consequences of the preferred option?

While there are obviously several different approaches to assessing the impact of the the preferred option on low-carbon indices, responding to the questions above would mean the IA report is much closer to assessing this preferred option against the objective of reorienting capital flows.

4

Recommendations

Despite one of the objectives of the SFAP and the legislative proposals discussed in this paper being to reorient capital flows, the relevant IA report does not contain any thorough assessment of the extent to which these legislative proposals are expected to contribute towards reorienting capital flows.

2DII is not the first to articulate concerns about the IA process. Other commentators have remarked that ever since the Guidelines were established, 'the impact assessments of the financial legislation have continued to ignore these tools, and have lacked of a serious methodology to understand these social and environmental impacts.'⁴⁸ These criticisms are far wider than the strict focus of this paper on the extent to which any assessment of reorienting capital flows has taken place.

In fact, a recommendation from the High-Level Expert Group on Sustainable Finance (**HLEG**) precisely addressed this issue in its articulation of a *Think Sustainability First* principle.

*'There is a need to incorporate the 'Think Sustainability First' principle as a core approach for the application of the Commission's Better Regulation Guidelines. The Better Regulation Guidelines provide the tools to equally assess economic, social and environmental impacts. But to ensure that a chosen financial services policy or legislation proposal is contributing to the SDGs, an ESG assessment needs to be taken into account more effectively throughout the various steps of the policy-making process.'*⁴⁹

The HLEG recommendation singles out the IA as where this principle would be most beneficial as it 'could clarify how legislation and regulation is stimulating EU finance to be supportive of long-term investment considerations, and environmental and social sustainability – especially where this is prevented by current market dynamics and market failures.'^{50 51}

Unfortunately, this recommendation did not flow through into the SFAP.⁵² While focused on strengthening the existing IA process, it does not go as far as articulating further requirements for any impact assessment which relates to an objective of reorienting capital flows.

In this context, where the objective for a financial policy relates to reorienting capital flows, further tools and guidance are imperative to assist with qualitative and quantitative assessment of the likely magnitude of reoriented capital flows to ensure a recommended policy option is optimal. Accordingly, we would add the following recommendations in support of those put forward by the HLEG.

⁴⁸ Vander Stichele, M., 2017. HLEG. A sustainability test for the regulatory process: a good start. In Responsible Investor

⁴⁹ EU High-Level Expert Group on Sustainable Finance, 2018. Final Report: Financing a Sustainable European Economy, p.61

⁵⁰ EU High-Level Expert Group on Sustainable Finance, 2018. Final Report: Financing a Sustainable European Economy, p.61

⁵¹ The HLEG recommendation in this regard is comprehensive and summarised as follows:

Strengthen and improve the implementation and application of existing rules and policies. This would include the development of a clear and robust set of internal guidance to take due consideration of ESG and broader sustainability impacts and how to implement the Think Sustainability First principles throughout the policy making and implementation process with all key institutions including the European Parliament, the Council and the ESAs.

Embed the 'Think Sustainability First' principle throughout the decision-making, implementation and enforcement process. This would include incorporating sustainability expertise and action into the role of the Regulatory Scrutiny Board and ensuring that before proceeding to interservice consultation, the Board is satisfied that the principle has been applied.

Monitoring and follow up. This would include implementing various measures such as reference indicator frameworks and monitoring obligations to review the SDGs in the EU context (EU High-Level Expert Group on Sustainable Finance, 2018. Final Report: Financing a Sustainable European Economy (paraphrased from pp.62-63)).

⁵² Rather the SFAP contains the statement 'The Commission will ensure that any relevant impact of financial services legislation on sustainability is properly assessed in the relevant impact assessments, public consultations and ex-post evaluations, in line with the Better Regulation guidelines and toolbox.' (COM (2018) 97 p.12)

4.1 Recommendation 1: Develop a new tool for the Better Regulation Toolbox

A new tool should be developed which addresses methodological challenges associated with qualitative and, when possible, quantitative assessment of the likely magnitude of reoriented capital flows

As set out previously, the Toolbox contains specific tools for improving key aspects of the IA process in specific circumstances. Currently, the Toolbox does not include any specific assessment tool for sustainable finance policies, while it does for other sectoral policies (e.g. social policies (tool #11)).⁵³ There is an urgent need to develop a new tool which should take into account specific challenges related to sustainable finance policies.

Assessment of sustainable finance policies goes beyond the more traditional evaluations and analytical frameworks currently included in the Toolbox. However, the world has moved on since the SFAP was published and since the Guidelines and Toolbox were last updated. There is now more recognition of the need to develop and improve analytical frameworks for this purpose.

In recent years there has been a steady increase of methodologies and tools dedicated to providing alignment metrics which may assist with assessing the extent of any reorientation of capital.⁵⁴ Among these tools, the PACTA tool developed by 2° Investing Initiative measures alignment of financial portfolios with various low-carbon transition scenarios and through coordinated projects can assess aggregate alignment of a large number of financial institutions with such scenarios. Another key initiative is the Green Finance Platform and Grantham Research Institute which has established a collaborative working group on sustainable finance effectiveness.⁵⁵ Furthermore, research on the impact of sustainable finance policies increases steadily with papers on the Green Supporting Factor⁵⁶ or other sustainable finance policies such as the impact of green finance taxes.⁵⁷

2DII will continue to research this area to articulate what should be included in a new tool for this purpose. We are planning to suggest new guidance which will leverage the most recent knowledge in sustainable finance research to outline how to articulate a theory of change aimed at reorienting capital flows in a timely manner and taking into account financial markets' specific characteristics.

⁵³ Feedback from stakeholders consulted during drafting of this paper revealed a concern that the tools which exist now tend to prioritise business as usual thinking (e.g. sectoral competitiveness, narrow cost-benefit analysis focussing on regulated entities rather than on society as a whole) over sustainability considerations (such as consistency with the European Green Deal) and are therefore counterproductive for achieving sustainable finance goals and sustainability goals more generally.

⁵⁴ Institut Louis Bachelier et al., 2020. The Alignment Cookbook - A Technical Review of Methodologies Assessing a Portfolio's Alignment with Low-carbon Trajectories or Temperature Goal

⁵⁵ <https://www.greenfinanceplatform.org/>

⁵⁶ 2° Investing Initiative, n.d. The Green Supporting Factor – Quantifying the impact on European banks and green finance

⁵⁷ Thomae, J. and Schoenauer, A., 2021. How can financial sector taxes contribute to climate goals? A review of policy options

4.2 Recommendation 2: Increase scrutiny of the formulation of the policy objective

The Regulatory Scrutiny Board should provide greater scrutiny and oversight of the formulation of the policy objective and the link to EU overarching climate objectives

The definition of the policy objective shapes what the IA must achieve and answer.⁵⁸ Therefore, if the definition of the policy objective in the IA report is not (adequately) linked to the objective to reorient capital flows, then the need to assess the various policy options against this objective can get lost in the IA process.

In relation to the IA report examined for this paper, while the general objective is explicitly linked to the SFAP objective of reorienting capital flows, any analysis focusses on the specific objectives articulated, and the assumptions which link the specific objectives and the general objective of reorienting capital flows are not analysed. It appears that the distinction between general objectives and specific objectives has resulted in the assessment being distanced from the objective of reorienting capital flows.

As the Guidelines state, the IA should enable scrutiny of the logical chain between the problem being addressed and the options considered for addressing that problem. Furthermore, a clear explanation should be provided on the relationship between the specific goal of any policy initiative with any wider EU horizontal objectives and political goals.

In the current context, if further IAs are structured in the same way (general objectives to reorient capital flows and specific objectives on a more granular level) then it is quite conceivable that no IA will assess the extent to which the policy initiative contributes to reorienting capital flows. While there is clearly a need to link a policy initiative to wider EU horizontal objectives and political goals, this process should not have an unintended consequence of introducing an untested step in the logical chain which is a critical premise for why any particular policy works.

Alongside developing a new tool for the Toolbox in relation to methodological challenges associated with qualitative and quantitative assessment of the likely magnitude of reoriented capital flows, then stricter oversight by the Regulatory Scrutiny Board of the formulation of the policy objective and the link to EU overarching climate objectives will greatly improve the quality of IA reports in this area.⁵⁹ This increased oversight should operate in synergy with the new tool for the Toolbox.

⁵⁸ In particular, the IA should articulate to what extent each policy option tackles the identified problem and meets the policy objective.

⁵⁹ Feedback from stakeholders consulted during drafting of this paper revealed concerns about transparency related to the Regulatory Scrutiny Board's operating procedures and processes. This would imply that a review of these procedures and processes is required, together with a review of the public accountability mechanisms that the Regulatory Scrutiny Board is subject to.

4.3 Recommendation 3: Enhance specific expertise of key constituencies

Constituencies involved in sustainable finance policy making must increase their technical expertise in relation to the latest research which is relevant to assessing reorientation of capital flows

DG FISMA (as the Directorate General likely to be leading many sustainable finance policy initiatives) and the Regulatory Scrutiny Board (as the body responsible for reviewing the IA report and providing a positive opinion for policy making activities to continue) must take steps to increase their expertise in this area. While broader sustainable finance expertise may already exist in these organisations, a specific expertise in relation to recent sustainable finance research and methodologies for measuring alignment (which may assist with reorientation of capital) is lacking. And as mentioned previously, there has been a steady increase in research output in this area.

But there are other bodies in the EU constitutional architecture which are also relevant. Certain policy files which relate to (albeit less so) the objective of reorienting capital flows may be led by another Directorate General. Where this is the case, then specific attention is required to ensure that any IA is adequate (e.g. through sharing expertise or enacting specific procedural measures for these IA reports). Clearly the ESAs also have a key role to play in policy making in this area.

In addition, the Platform on Sustainable Finance⁶⁰ has several aspects to its remit, including:

- ‘monitor and regularly report to the Commission on trends at Union and Member State level regarding capital flows into sustainable investment’ and
- ‘advise the Commission on the evaluation and development of sustainable finance policies, including with regard to policy coherence issues.’⁶¹

These two aspects (monitoring capital flows and advising on sustainable finance policies) mean that a focus on the ability of any sustainable finance policy to contribute to reorienting capital flows is central to its remit. Yet despite these aspects to the Platform’s mandate, there is little further detail as to how the Platform can leverage its position and expertise to improve the IA process for sustainable finance policy. Alongside improving the expertise of the key organisations involved in sustainable finance policy making, clarifying the role of the Platform should further improve the quality of IA reports in this area.

⁶⁰ Established by Art 20, Taxonomy Regulation and composed in a balanced manner of representatives of EU bodies (such as the European Environment Agency, ESAs etc.) and experts representing private stakeholders, civil society, academia and those appointed in a personal capacity. At the time of this paper, the Platform is established and the first round of recruitment has been finalized.

⁶¹ Art 20, Taxonomy Regulation

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Conclusion

This paper articulates one example of how actual practice in relation to conducting the IA differs from the theoretical ideal. Concerns as to IA practice have been raised before. And these concerns have merited a HLEG recommendation as to how to address them. However, where sustainable finance policy has an objective to reorient capital flows, we consider that our own recommendations are required in addition to those of the HLEG to ensure that IAs are fit for purpose.

One criticism of the analysis in this paper could be that in reality it is difficult to separate out specific sections of the IA report and focus the analysis exclusively on those specific sections. The Guidelines must necessarily cater for IAs in a variety of different contexts and therefore permit flexibility in terms of what information is put where.

Therefore, other areas of the IA report can also be relevant to the scope of analysis in this paper. However, this does not alter the general conclusion of this paper – that the relevant IA report for the legislative proposals under the SFAP does not contain any robust assessment of the extent to which these legislative proposals are expected to contribute towards reorienting capital flows.

A further criticism of the analysis in this paper is that it is somewhat ‘past its sell by date’. What is the point in analysing the IA report for legislation which has now been implemented?

In response, the European Green Deal reveals that the Commission is looking to improve the Guidelines and supporting tools to address sustainability and innovation issues.

‘The objective is to ensure that all Green Deal initiatives achieve their objectives in the most effective and least burdensome way and all other EU initiatives live up to a green oath to ‘do no harm’. To this end, the explanatory memorandum accompanying all legislative proposals and delegated acts will include a specific section explaining how each initiative upholds this principle.’⁶²

While we welcome the Commission’s attention to this area and the apparent ambition in the green oath to ‘do no harm’ –further detail is required. Our recommendations specify improvements which are necessary in the context of financial policy making with an objective to reorient capital flows.

We consider that a new tool should be developed for the Toolbox to ensure that the research advances in relation to alignment metrics (e.g. through the work of the Green Finance Platform and Grantham Research Institute collaborative working group on sustainable finance effectiveness or otherwise) are integrated into the IA process. 2DII will continue to research this area to articulate what should be included in a new tool. Further, the Regulatory Scrutiny Board should provide greater scrutiny and oversight of the formulation of the policy objective and the link to EU overarching climate policies. And finally, constituencies involved in sustainable finance policy making must increase their technical expertise in relation to the latest research which is relevant to assessing reorientation of capital flows.

In July 2021, the Commission published its Sustainable Finance Strategy.⁶³ This is a commitment under the European Green Deal which resets the Commission’s commitment to

⁶² COM (2019) 640 p.19

⁶³ The Commission released a consultation on what might be included in this Renewed Sustainable Finance Strategy in Summer 2020.

tackling climate and environmental-related challenges. It heralds the next phase of sustainable finance policy making in the EU and sets out the Commission's agenda for implementation of a new set of sustainable finance policy files. And at the end of 2021, the parties to the Paris Agreement will meet for COP26 in Glasgow. This is widely regarded as a "make or break" COP and comes in the context of the Initial NDC Synthesis Report showing that nations must submit more ambitious national climate action plans in 2021 if they are to achieve the temperature goals in the Paris Agreement by the end of the century.⁶⁴

This means policymakers do not have a moment to lose and cannot afford any mistakes. In the climate context, a slow reorientation of capital flows entails locking in future greenhouse gas emissions while delaying greenhouse emissions reductions - therefore increasing the required decarbonisation rate in the future to remain within stable climate boundaries.⁶⁵

To conclude, any policy initiative under the Sustainable Finance Strategy which relates to reorienting capital flows must be subject to an elevated standard of impact assessment as advocated for in this paper and conform to the broader principle of better regulation to ensure optimal design. 2DII will continue to research this area and respond to the gaps identified in this present paper. We are planning to suggest new guidance to address the specific challenges involved with designing effective sustainable finance policies which meet the objective of reorienting capital flows.

⁶⁴ <https://unfccc.int/process-and-meetings/the-paris-agreement/nationally-determined-contributions-ndcs/nationally-determined-contributions-ndcs/ndc-synthesis-report#eq-5>

⁶⁵ This has been acknowledged by the Net-Zero scenario of the International Energy Agency (2021), which require no new fossil fuel investments.

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