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The EU sustainable finance strategy – Implications for the future German Federal Government

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At a glance

- The EU's revised sustainable finance strategy confirms the important role of the financial sector in the sustainability transition of the economy, but does not sufficiently spell out the details of it. Many of the actions are welcome, but often lack urgency and momentum.
- The strategy should be placed more firmly in the macroeconomic regulatory environment to support the interaction of different policy instruments such as CO2 disclosure requirements and CO2 pricing.
- The definition of sustainability risks remains very general. In particular, transition risks should be explicitly taken into account from now on in addition to physical risks.
- In the light of the enormous importance of the building sector for climate protection, the green credit and mortgage market should be further developed.
- Linking the strategies for digital technologies and data management to the sustainable finance strategy not only at EU level but also at national level is crucial.
- The strong focus on climate protection disregards other important environmental goals of the Green Deal, such as biodiversity and social factors.
- Disclosure and reporting requirements for small and medium-sized enterprises should be combined with concrete standards and external audit mechanisms.
- As regards the public sector, more far-reaching requirements should be imposed in terms of the achievement of climate targets, disclosure and reporting obligations, and the measurement of sustainability risks and impacts of investments.
- A stronger commitment to ESG on the part of institutional investors should be supported by a German stewardship code and uniform standards.

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Introduction and general assessment

The revised sustainable finance strategy[2] is primarily aimed at fully implementing and complementing the EU Action Plan adopted in 2018[3]. This had essentially led to the implementation of three building blocks to channel capital into sustainable economic activities: (1) the EU taxonomy[4], (2) a more comprehensive disclosure regime[5] as well as (3) standards and labels for sustainable financial instruments.

The revised strategy, presented in July 2021, is based on the following four pillars: (1) Financing the transition of the real economy towards sustainability, (2) Towards a more inclusive sustainable finance framework, (3) Improving the financial sector's resilience and contribution to sustainability: the double materiality perspective, and (4) Fostering global ambition.

The financial sector has an important role to play in the restructuring of the economy due to its leverage effect. The strategy articulates the following goals: Climate neutrality by 2050 in the EU and associated reduction of greenhouse gas emissions by at least 55% by 2030 compared to 1990 levels, strengthening resilience to climate change, reversing biodiversity loss and often irreversible degradation of the environment and key natural resources such as soils and water as a whole.

The EU strategy remains extremely vague and non-binding in many aspects[6] when it comes to designing the role of the financial sector – many actions are also made contingent on the consultation of other stakeholders. There is also a lack of urgency and momentum in many points – for example, in the actions to improve the resilience of the financial sector and its contribution to sustainability, which are fundamental to a transformation towards a sustainable future (Actions 3 a–e).

[2] Cf. COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS Strategy for Financing the Transition to a Sustainable Economy, COM/2021/390 final by July 6, 2021 (available online, last access October 7, 2021. This also applies to all other online sources of this report, unless stated otherwise). In this Policy Brief we use the short version "strategy".
[3] Cf. COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE EUROPEAN COUNCIL, THE COUNCIL, THE EUROPEAN CENTRAL BANK, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS Action Plan: Financing Sustainable Growth, COM/2018/097 final by March 8, 2018 updated August 5, 2020) (available online).
[4] See also Policy Brief – 3/2021 (available online) and Policy Brief – 4/2021(available online of the Sustainable Finance Research Platform).
[5] See also Policy Brief – 7/2021 of the Sustainable Finance Research Platform (available online).
[6] There are many phrases such as "will work on it" (bond labels, p.6), "may consider" (revision of the Prospectus Regulation, p.7) or "will ask the European Banking Authority (EBA) for its opinion" (regarding green retail loans and green mortgages, p.7).

Another point of criticism is that the technical criteria for the environmental goals of water, circular economy, pollution and biodiversity will now not to be adopted until the second quarter of 2022.

Welcome proposals for the financial sector are the climate-related revision of the Capital Requirements Directive (CRD IV) and the Capital Requirements Regulation (CRR) to support international initiatives, as well as the regularly scheduled climate-related stress tests. Since almost all economic sectors are dependent on resources such as water and soil, which are provided by ecosystems, the stress tests should consequently be extended to other key environmental risks. Biodiversity in particular has not been given sufficient attention so far, but it is of central importance as a basis for many industries such as tourism, automotive, food, pharmaceuticals and raw materials.

In principle, the strategy places a strong focus on private financial market players, and thus few concrete demands are imposed on the public sector. Given the hundreds of billions of euros in stimulus and economic development programmes in the wake of the pandemic and the dominant role of sovereign bonds in international bond markets (68% of global bonds are issued by sovereigns or supranational institutions)[7], it is also difficult to understand, in light of increasing disclosure requirements imposed on the private sector, why the strategy lacks any requirements for more transparency regarding environmental, social and governance (ESG) risks and impacts of the public sector.

In addition, for non-financial companies – and this is also not sufficiently emphasised in the strategy – there is a need for a more concrete regulatory framework, including financial incentives (e.g. CO2 prices and instruments to hedge regulatory risks); norms and standards (e.g. for new buildings or products); clear regulatory frameworks for green infrastructure development; the promotion of innovations and further training measures; and concrete, binding and forward-looking stimulus for financing the transformation.

In the following, we outline our recommendations for action for the next German Federal Government as regards risk management, stress tests and credit ratings,

[7] International Capital Market Association (2020), Global Bond Markets (available online, last access September 7, 2021).

green mortgages and loans, digital technologies, biodiversity, sustainability reporting, disclosure requirements as well as stewardship and engagement. The German Federal Government should take a proactive role with regard to the further development and implementation of these issues in order to successfully advance the European strategy.

Risk management, stress tests and credit ratings[8]

The strategy proposes actions to strengthen the resilience of the financial sector to counter ESG risks (Action 3)[9]. It makes sense to identify and transparently report these risks at all three relevant levels (company/asset, financial institutions and financial system). However, this is a complex challenge for financial institutions that should not be underestimated. This is because an excessively aggregated and blurred view of these risks can result in unintended adverse effects. For example, an excessively short-term and incomplete risk assessment can lead to misallocation of capital. Successful risk management that avoids unintended adverse effects therefore requires clear and explicit risk definitions.

Both stress tests carried out by regulators and internal risk management in companies and financial institutions must consider extreme transition risks[10] — explicitly taking into account, risks associated with CO2-intensive assets and business models due to short-term and rapid tightening of climate targets and policies. This is because, in addition to physical risks, transition risks in particular can pose a threat to the stability of financial institutions and markets (Battiston et al, 2017). Thus, not explicitly taking them into account increases the risk that companies and financial market institutions will bet on state protection in the event of a systemically relevant occurrence of such risks. Risky CO2-intensive investments

[8] Authors of this chapter: Karsten Neuhoff and Franziska Schütze (DIW Berlin), Ulf Moslener, Oliver Schenker and Karol Kempa (Frankfurt School) as well as Christian Klein (University of Kassel).
[9] On the one hand, the European Commission wants to ensure that ESG risks are captured in accounting standards and, on the other, that they are captured in ratings and rating outlooks. With regard to stress testing, the Commission intends to propose amendments to the Capital Requirements Regulation and the Capital Requirements Directive (banks), as well as the Solvency II Directive (insurers) (Action 3 c and d), which should include climate scenarios and climate change-related stress tests. Specifically, the Commission envisages a targeted "fit for 55" scenario, aligning itself with the new EU climate target and the policy framework envisaged for it.
[10] According to the „taskforce on climate-related financial disclosure" (TCFD) the definition of transition risks is as follows: „Transitioning to a lower-carbon economy may entail extensive policy, legal, technology, and market changes to address mitigation and adaptation requirements related to climate change." (TCFD, 2017).

would thus be implicitly backed by the state, and the financial market would continue to contribute to the problem instead of solving it.

In order for transition risks to be considered in risk management, metrics and analytical methods must be in place to identify these risks for individual companies and facilities. Therefore, it is necessary to assess how well prepared a company, facility or building is to accelerate the transition to carbon neutrality. For such a comparable and quantifiable assessment, the regulatory requirement of a reference scenario (stress test scenario) is indispensable.

This scenario must be uniform across all sectors of the real and financial economy in order to minimise administrative burden and maximise effectiveness and should therefore be established at the level of the EU strategy. It is of key importance that such a scenario does not examine the consequences of likely decarbonisation paths based on current policies such as the "fit-for-55" programme, but rather assumes an unexpected and faster structural change. Such a scenario could assume that climate neutrality must be achieved as early as 2035 (as already proposed in the final report of the German Government's Sustainable Finance Committee).

Most systemic stress testing approaches focus on generic sectoral risk parameters. If, for example, capital requirements for banks are derived from this, companies specifically in sectors with a large ecological footprint today and therefore a particularly high need for investment during the transformation might risk to be confronted with more difficult access to financing. At the same time, if dynamic risk measurement is incorrectly designed, there is a risk of "sustainability short-termism" if financial market players become more risk-averse with regard to financing new sustainability technologies and have excessively strong incentives to invest in "low-hanging fruits" of established sustainable business models.

A risk analysis and assessment must therefore focus on the company-specific risks and transformation paths.[11] This requires the regulatory requirement of a uniform transition scenario.

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[11] See also Policy Brief – 5/2021 of the Sustainable Finance Research Platform.

In this context, it is gratifying that the strategy highlights the special role of rating agencies. The role of these companies is to assess the creditworthiness of states, companies or financial instruments. According to their own information, rating agencies take ESG factors into account when preparing their ratings. However, the extent to which this is done is not transparent and varies depending on the asset class and the methodology used by the respective rating agency. The European Commission announces that, subject to a review by the European Securities and Market Authority (ESMA), it intends to take actions by the first quarter of 2023 to ensure that relevant ESG risks are systematically recognised in ratings (Action 3b). In addition, transparency about the way agencies take ESG risks into account in ratings and outlooks is to be improved. This has already been included in Recommendation 13 of the Sustainable Finance Committee.

In our view, transparent and consistent consideration of ESG risks in credit ratings is important for lenders, who need to be confident that sustainability risks, such as the consequences of transformation on a company's business model, have been duly considered. Moreover, the rated entity has more clarity about its own sustainability risks.

In this context, it is important that ESG ratings also consider the consequences of likely decarbonisation pathways as well as the impact of unexpected and faster structural change.

Green mortgages and loans[12]

The strategy includes two specific projects to support the development and use of green loans and green mortgages (Action 2a). In principle, this is to be welcomed, as the building sector must make an important contribution to climate neutrality. Firstly, the European Banking Authority (EBA) will be asked for an assessment by the

[12] Author of this chapter: Franziska Schütze (DIW).

end of 2022. On the other hand, the review process associated with the Mortgage Credit Directive[13], which is already underway, is to examine how the development of energy-efficient mortgages can be supported by the end of 2022. Specifically, Action 3c) addresses the fact that the energy efficiency of buildings can increase the value of buildings. The strategy merely states that the European Commission proposes to take this into consideration, but without defining concrete steps. Moreover, in the conclusion, the review process of the Mortgage Credit Directive thus far only very vaguely addresses a possible adaptation of the credit assessment to address climate and environmental aspects (p. 19). In comparison, the German Sustainable Finance Strategy has not addressed the issue of buildings and mortgages, although the Sustainable Finance Committee has set out clear recommendations in this regard (see Action 30[14]).

In the light of the enormous importance of the building sector for climate protection, the actions contained in the European strategy are excessively non-binding or completely omitted in the German strategy. Here, too, scenarios about the future development of climate policy (increased energy prices, minimum requirements for existing buildings, or similar) must be included in the credit assessment and the valuation.

We therefore recommend that the German Federal Government become more actively involved in the design and further development of the green mortgage market, by incorporating transition scenarios in the credit assessment and building valuation in law.

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[13] Cf. Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements relating to residential immovable property concluded by consumers and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010 Text with EEA relevance (available online, last access September 10, 2021); according to §44 of the Directive, a review of its effectiveness and adequacy should be carried out by 21 March 2019. In fact, the review of the Directive was published in May 2021 (available online, last access September 10, 2021).

[14] "The Council recommends to the Federal Government to establish an information infrastructure for raw sustainability data, set up a building energy database, and anchor building energy quality as a value factor in the rules of the building valuation."

Digital technologies[15]

The European Commission already highlights in the Green Deal[16] the importance of digital technologies such as artificial intelligence (AI), blockchain and other distributed ledger technologies (DLT), machine learning, mobile apps and platforms, Big Data and the Internet of Things (IoT) as crucial prerequisites for the transformation process towards sustainability, tackling climate change and protecting the environment. The strategy also mentions the importance of digital technologies for consumers and small and medium-sized enterprises (Action 2b). The aim is to provide access to sustainable financing, increase the use of digital sustainable financial instruments and promote understanding of the sustainability impacts of financial products. Furthermore, the European Single Access Point (ESAP)[17] and the Open Finance Framework[18], which are to serve as a kind of catalyst to leverage the potential of digital technologies, are referenced.

Digital technologies, and AI in particular, are cross-cutting technologies that bring both benefits and risks. Digital technologies significantly increase the consumption of energy and resources – for example, through energy-intensive data centres and the training of an AI – and thus carry the risk of negative environmental impacts. The EU announcement to make these infrastructures climate neutral and energy efficient by 2030 and to expand the technical verification criteria for data centres and digital solutions in the delegated act on climate to include further activities on the development of sustainable digital solutions and the use of sustainable crypto assets is to welcome.

However, it is surprising that the strategy does not interlink with other legislative initiatives and projects in the field, for instance the Digital Finance Strategy[19], the

[15] Author of this chapter: Catherine Marchewitz (DIW).
[16] European Commission (2019). The European Green Deal, p.11.
[17] The ESAP is intended to be a public database providing access to standardised financial and sustainability data of reporting companies in the EU, which in turn will be analysed and processed using digital technologies. A legislative proposal for this shall be presented in autumn 2021.
[18] The Open Finance Framework, for which the EU Commission intends to present a proposal in 2022, is intended to facilitate the exchange of financial data.
[19] Cf. COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS on a Digital Finance Strategy for the EU, (available online, last access September 6, 2021). The Digital Finance Strategy contains two strategy papers, one on the general digital transformation of finance and the handling of associated risks, the other on modern and secure payment transactions. Europe is to be strengthened as a location for financial technology and digital and data-driven innovations are to be promoted on the corporate side. Consumers should benefit from greater data sovereignty (including uniform digital identities) and better access to cross-border financial services.

Data Strategy[20] as well as the Artificial Intelligence Act[21] and the Coordinated Plan on Artificial Intelligence 2021 Review[22]. The above-mentioned efforts at EU level and legislative projects can have significant changes and impacts on the European but also national Sustainable Finance Strategy, as they set the framework for digital technologies in general as well as for data management in the EU. Hence, it would be appropriate to link the areas even more strongly in the future and also to discuss more about sustainable digital finance (Puschmann, Leifer 2020).

The transformative potential of sustainable digital finance should be given greater consideration in interdisciplinary research. Linking the strategies for digital technologies and data management to the sustainable finance strategy not only at EU level but also at national level is crucial. The future German Federal Government should take this into account. A common robust standard for data is the basic prerequisite for fulfilling reporting and disclosure obligations, increasing transparency, reducing information asymmetries and gaining insights into market trends.

Biodiversity[23]

The joint report of the two leading international scientific bodies on biodiversity and climate change, the Intergovernmental Science-Policy Platform on Biodiversity and

[20] Cf. COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS A European strategy for data, (available online, last access September 6, 2021). The European Data Strategy outlines the goal of creating a single European data space where data is shared in a simplified way. It also mentions that making more data available and improving the way data is used is crucial to addressing societal, climate and environmental challenges. On 28 May 2021, the EU Commission published its impact assessment for a so-called "Data Act" and aims for a draft regulation in the fourth quarter of 2021.
[21] See Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL LAYING DOWN HARMONISED RULES ON ARTIFICIAL INTELLIGENCE (ARTIFICIAL INTELLIGENCE ACT) AND AMENDING CERTAIN UNION LEGISLATIVE ACTS, (available online, last access September 5, 2021). The Artificial Intelligence Act aims to create a uniform legal framework in particular for the development, marketing and use of artificial intelligence. In addition to a definition and harmonised regulations, a binding set of rules for AI systems is to be introduced.
[22] See ANNEXES to the Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions Fostering a European approach to Artificial Intelligence, (available online, last access September 5, 2021). The Coordinated Plan on Artificial Intelligence 2021 Review proposes a set of specific actions with a clearly defined timeline and possible cooperation and funding mechanisms. Among other things, the goal is to gradually increase public and private investment in AI over the decade to a total of 20 billion euros per year.
[23] Authors of this chapter: Malte Hessenius, Ingmar Jürgens and Liyana Nayan (Climate & Company) and Franziska Schütze (DIW).

Ecosystem Services (IPBES) and the Intergovernmental Panel on Climate Change (IPCC), has highlighted the importance of addressing biodiversity loss and climate change in unison. As the biodiversity crisis has come to the forefront in recent years, it would have been crucial to go beyond climate action and to include biodiversity protection much more prominently in the strategy. Unfortunately, this has not occurred, even though funding plays a central role in achieving the EU biodiversity strategy[24] and the UN species conservation goals under the Convention on Biological Diversity (CBD).

The EUR 100 billion earmarked for biodiversity under the EU Multiannual Financial Framework and the EU Recovery Plan is a significant increase on the EUR 12.2 billion the EU spent on biodiversity between 2015 and 2017[25]. However, this is far from enough to cover the estimated annual funding needs for biodiversity of EUR 607 to 813 billion. For comparison: an estimated EUR 420 billion is spent annually globally on financial activities that are detrimental to biodiversity[26].

In the first EU action plan from 2018, other environmental aspects were identified as threats to the financial sector in addition to climate risks, but without making specific recommendations on biodiversity protection. The strategy now proclaims the vague goal of aligning all sources of finance with global goals such as "reversing" biodiversity loss. In addition, the strategy promises greater involvement of industry in accounting for biodiversity and natural capital, a methodological report by 2022 on the assessment of financial risks related to biodiversity, and declares to further strengthen the mainstreaming of biodiversity in the EU budget (Action 1d). In addition, the strategy mentions existing processes such as the EUR 100 billion spending target for biodiversity in the multi-annual EU budget and the Next Generation EU Initiative, and refers to the process on EU taxonomy and the upcoming criteria for Environmental Goal 6 (biodiversity and ecosystems).

Overall, biodiversity is overshadowed by climate issues and the strategy is one of intent, lacking a clear roadmap. In the section on insurance, the Commission only

[24] For further information please visit the website of the European Commission (last access September 10, 2021).
[25] OECD (2020). A Comprehensive Overview of Global Biodiversity Finance. (available online, last access September 10, 2021).
[26] The Paulson Institute, The Nature Conservancy, and the Cornell Atkinson Center for Sustainability (2020). Financing Nature: Closing the global biodiversity financing gap (available online, last access September 10, 2021).

refers to the "climate protection gap", but not to the considerable risks associated with the dependence of many economic activities (such as agriculture and forestry, the food industry, water suppliers, etc.) on environmental and ecosystem services. Part 3 (c) of the action plan ("annex – detailed actions") associated with the strategy proposes a practical revision of the CRR/CRD framework, but does not go beyond climate change mitigation and does not mention biodiversity and other important environmental risks. So, the discussion here is only limited to climate stress tests.

Even the welcome announcement to strengthen global ambitions on disclosure obligations focuses exclusively on climate protection measures and mentions the Task Force on Climate-related Financial Disclosures (TCFD), but not the Task Force on Nature-related Financial Disclosures (TNFD)[27] – and this despite the global ecological benefits of ecosystems and biodiversity and the significant potential risks associated with them.[28]

In order to achieve the ambitious goal of the EU Biodiversity Strategy and to "reverse" the loss of biodiversity, there are several recommendations for action, both for decision-makers in the EU institutions and for the German government.

1. **Develop an ambitious timetable with concrete steps on how the EU biodiversity strategy can be supported by the financial sector, i.e. to what extent EU sustainability reporting rules take biodiversity sufficiently into account (e.g. EU taxonomy, CSRD, EU budget). Support the Global Task Force on Nature-based Financial Disclosure (TNFD), which defines key metrics, or the Science Based Targets Initiative, which helps companies implement them;**
2. **the obligation to conduct stress tests should go beyond the issue of climate, as the Dutch central bank has already shown with its report on "biodiversity dependency risks"[29];**
3. **While (mandatory) disclosure of accurate, comparable indicators increases transparency, it must be accompanied by measures to price negative biodiversity/environmental impacts[30] in order to correct the current market failure;**
4. **A strong framework is needed to channel private financial flows into relevant economic activities. Policymakers should create incentive schemes for private**

[27] "Measure 13 of the German Sustainable Finance Strategy states: "The measurement of the impact of activities on biodiversity and natural capital should be improved, inter alia, by the German government's supportive involvement in the development and implementation processes of the Task Force on Nature-related Financial Disclosures (TNFD).
[28] Further information on the website of DNB (last access September10, 2021).
[29] Ibidem
[30] Further information on the website of Eurosif (last access September 7, 2021).

capital, such as payments for ecosystem services, environmental risk insurance and trust funds.

Sustainability reporting[31]

The EU Strategy attaches key importance to mandatory disclosure as one of three interlinked building blocks of the EU framework for sustainable finance. Instruments for this have already been prepared or implemented with the proposal of the Corporate Sustainability Reporting Directive (CSRD), the Sustainable Finance Disclosure Regulation (SFDR) and the taxonomy. In this context, the strategy highlights that the principle of double materiality plays a key role in considering both financial sustainability risks for financial companies and products and their impact on sustainability aspects. It is also noteworthy that small and medium-sized enterprises (SMEs) are explicitly addressed. Among other things, the strategy emphasises that the inclusiveness of sustainable finance can only be achieved if SMEs have better access to sustainable financial services. An important step towards achieving this goal is, of course, the development of disclosure standards for SMEs under the CSRD.

The strategy announces the development of a simplified reporting standard and support for voluntary disclosure by SMEs. Listed SMEs will have to disclose sustainability information for the first time for the 2025 financial year under the CSRD, while non-listed SMEs are encouraged to report voluntarily. This is not enough, because important sectors that are crucial for achieving the environmental goals set out in the Taxonomy Regulation (and the EU Green Deal), such as construction or agriculture, are characterised by small, non-listed companies which account for 80–90% of the economic activity in those sectors.[32]

An important element of credible sustainability reporting is the external verification of the published information. While the CSRD contains initial proposals for the due

[31] Authors of this chapter: Frank Schiemann (University of Hamburg), Katharina Erdmann, Ingmar Jürgens and Blerita Korica (Climate & Company).
[32] See also Policy Brief - 8/2021 of the Sustainable Finance Research Platform (available online).

further development of the review of sustainability reporting, the strategy does not address this important element.

International cooperation is essential in the context of the climate crisis and is also viewed as an important element in the action plan. Among other things, explicit reference is made to cooperation within the framework of the International Platform on Sustainable Finance (IPSF), the G20, the European Financial Reporting Advisory Group (EFRAG), ESMA, International Accounting Standards Board (IASB), and the combination of CDP, Climate Disclosure Standards Board (CDSB), Global Reporting Initiative (GRI), International Integrated Reporting Council (IIRC) and Sustainability Accounting Standards Board (SASB). The efforts to develop a global basic standard for sustainability reporting are to be welcomed, especially if, as emphasised in the Action Plan, all environmental dimensions can be included and the principle of double materiality can be adhered to. In the light of varying regulations and approaches worldwide, however, this is a major challenge that first requires a clear definition of goals and guidelines. A central role for the EU and its institutions is posited in the strategy, but not substantiated and, above all, not underpinned with a corresponding budget and specific process-related implementation concept, which would be necessary to provide invaluable impetus in this regard.

We therefore recommend that the German Federal Government actively participates in the development of standards, especially for SMEs, and supports them in their implementation. External audits should be considered to ensure proportionate application in the context of all ESG disclosure and reporting requirements for companies but also for financial products.

Disclosure requirements for the public sector[33]

The disclosure requirements for private companies were discussed in the previous section. The strategy for sustainable finance also includes elements that affect the public sector.

Action 5b) of the strategy states that member states should be supported in reducing the EU investment gap. However, this only applies to private investment, not to public spending and investment by member countries. Action 2e) states that the Commission will "strengthen methods for tracking climate and biodiversity spending, support those Member States that wish to set green priorities in their national budgets, and organise an annual preparatory summit on sustainable investments in the run-up to COP26". However, this measure is non-binding and Member States can undertake the inclusion of green priorities in their national budgets on a voluntary basis.

There is a great need for action regarding the methods for measuring climate expenditures and it is not clear whether Action 2e) meets this. For example, the target for climate expenditure is 37% for the development and resilience plans. Depending on how this 37% is measured, the contribution to climate protection also changes. The previous methodology of the so-called "OECD Rio Marker"[34] determines the significance of the individual household lines for the climate using three coefficients (insignificant 0%, moderate 40% and significant 100%) This is simple to apply, but has been sharply criticised by the European Court of Auditors[35]. Conversely, the criteria set out in the EU taxonomy are recommended to consider the urgently needed "substantial contribution to climate change mitigation".[36]

With regard to the Recovery and Resilience Facility (RRF) climate target and the Regional Fund, these Rio Markers have been improved by adding more technical details to the 100% coefficients. However, the method is not fully aligned with the EU taxonomy. Nor was an explicit exclusion list defined (i.e. a list of activities

[33] Authors of this chapter: Ingmar Jürgens (Climate & Company), Franziska Schütze (DIW Berlin), Oliver Herrmann, Malte Hessenius, Laura Kaspar and Simon Lehmann-Leo (Climate & Company).
[34] Further information on the website of the European Union (last access September 10, 2011).
[35] European Court of Auditors (2020). Tracking climate spending in the EU budget. (available online, last access September 10, 2021).
[36] Sweatman and Hessenius (2020). Applying the EU Taxonomy – lessons from the front line (available online, last access September 10, 2021).

incompatible with environmental objectives, as is now used by most financial institutions, including the European Investment Bank (EIB).[37] At the national level, only a few member states have green budgeting and the methods differ.[38]

Furthermore, the strategy emphasises that "the sustainable finance framework can facilitate the raising of sustainable capital by public entities". As an example, it is listed that 30% of the Next Generation EU budget is to be raised through green bonds. Public issuers can also voluntarily opt for the issuance of European green bonds[39]. A point of criticism is that they are "only" subject to the same reporting rules as private issuers. They are also given more leeway regarding the selection of external valuers of the green bonds. The public sector has a bearing on the market standard due to the amount and significance of its investment volume. It would therefore be desirable for it to follow a more far-reaching reporting obligation.

The recommendations of the Sustainable Finance Committee already include very detailed recommendations for public financial institutions (No. 29), as well as on public issues and public capital investments (Recommendations 1 and 2). The German Federal Government should implement these quickly and rigorously.

In particular, we recommend the extension of disclosure and reporting requirements for the public sector at all regional authority levels. Germany should lead by example here and thus set the standard in this area to facilitate and improve the sustainability assessment of public financial instruments (such as government bonds) with transparent and comprehensible ESG reporting.

Stewardship and engagement[40]

The European Commission calls for greater consideration of sustainability impacts in investors' strategies and investment decision-making processes and, in this context, would like to consider revising investors' fiduciary duties and stewardship

[37] Agora-Energiewende (2021): Matching money with green ideas. A guide to the 2021–2027 EU budget.
[38] Bova (2021). Green Budgeting Practices in the EU: A First Review.
[39] The Commission proposal for this has been introduced into the legislative procedure.
[40] Author of this chapter: Catherine Marchewitz (DIW).

arrangements (Action 4b). Thus, the fiduciary duties of investors and pension funds towards members and beneficiaries should also consider the ESG risks of investments as part of the decision-making processes. In principle, this is to be welcomed, because the capital investments of institutional investors and large capital collection agencies in particular have a considerable leverage effect due to their size alone.

Guidelines and standards for the performance of fiduciary investor duties (stewardship and engagement) have existed for some time at international level[41]. The concept has also been taken up at national level by several countries worldwide to date[42]; the UK was one of the pioneers in adopting a stewardship code back in 2010. Now the issue has also found its way into EU legislation, in particular the revised Shareholder Rights Directive 2019 (Revised Shareholder Rights Directive, SRD-II)[43]. The action vaguely outlined in the strategy also refers to this: thus, in the context of an examination of the SRD II Directive by 2023, it is also to be examined how impact assessments and global best practices in stewardship guidelines can best be incorporated into the Directive. New rules have already been introduced in SRD-II to further promote effective management and long-term investment decisions. This was an acknowledgement that greater shareholder participation in corporate governance can improve the financial and non-financial performance of companies. It provides a minimum standard for responsible asset management (stewardship activities), effective stewardship and long-term investment decisions. The Commission is also passing on responsibility by first asking the European Insurance and Occupational Pensions Authority (EIOPA) to consider the inclusion of ESG risks of investments as part of the decision-making processes, and then to make its decision.

Many countries have long adopted a code of best practice for the stewardship role of institutional investors and asset managers, most notably the UK in 2010[44]. Germany

[41] Since 2006 the UNPRI, since 2015 the OECD Principles for Corporate Governance and since 2017 the Stewardship Code of the industry association European Fund and Asset Management Association (EFAMA). In 2017, EFAMA adapted the Code of External Governance, which was published in 2011.
[42] See also International Corporate Governance Network (ICGN) (available online, last access September 6, 2021).
[43] Cf. Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement (available online).
[44] See also International Corporate Governance Network (ICGN) (available online, last access September 6, 2021).

has not yet followed this trend. While the issue has been addressed in various forms in various policies and guidelines, compliance is not actively monitored.[45]

As the German government's Sustainable Finance Committee has also noted, private and public investors in Germany rarely take advantage of the opportunity to use their say to encourage companies to operate more sustainably. However, especially for institutional investors with long-term payout obligations such as pension funds, stewardship also represents a risk management approach. For example, the possible transformation potential is currently not being exploited because investors shy away from the additional expense and legal uncertainties (Ringe 2021).

In this respect, recommendation 31 of the German government's Sustainable Finance Committee should be repeated here: it calls for a better infrastructure and an even stronger commitment to ESG on the part of institutional investors in Germany and also recommends the development of a German Stewardship Code as a guide for engagement activities.

Outlook

The German economy is undergoing a fundamental transformation process: Climate crisis, digitalisation and globalisation harbour risks but also opportunities. The financial sector undoubtedly has an important role to play here. In order to achieve the goals, set in the strategy, there is a need for better cooperation between the financial and real economy as well as the public sector.

The topics listed clearly show that there is still a lot to be done in terms of spelling out the details and implementing the Sustainable Finance Strategy at the European level.

[45] Since 2002 in the German Corporate Governance Codex, since 2003 in the BVI-Rules of Conduct as well as 2019 the provisions of the Act Implementing the Second Shareholders' Rights Directive (ARUG II) and in the Stewardship Guidelines der Deutschen Vereinigung für Finanzanalyse und Asset Management (DVFA).

The EU should engage in international cooperation by presenting concrete and ambitious proposals to advance basic standards in sustainable finance regulation.

But even at the national level, important stakeholders are not yet cooperating to the required extent. Many of the improvements and proposals we have outlined can already be found in the previous policy briefs of the Sustainable Finance Research Platform and in the recommendations of the German government's Sustainable Finance Committee, as well as in the German Government's Sustainable Finance Strategy under the aegis of the Federal Ministry of Finance and the Federal Ministry for the Environment. It is now necessary to tackle their implementation and to introduce the national initiatives into the European discourse in order to strive for an EU-wide regulation. Germany should spearhead this and play a more active role in shaping the further development of sustainable finance actions.

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About the project

The Sustainable Finance Research Platform is a joint project between five German research institutions conducting research on different aspects of sustainable finance, e.g. sustainable investments, sustainability risks and chances, and sustainability reporting. With their independent research, the project partners aim to support stakeholders in politics, the financial sector, and the real economy in understanding and shaping the central role of capital markets in achieving a net-zero economy. The researchers involved answer social, political, and business-related questions, provide established and new research findings, and participate in political and public debate. They also want to establish sustainable finance as a topic in the German research landscape and secure connections with international institutes and processes.

More information can be found on the project's website wpsf.de/en/.

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