Executive summary

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THE EUROPEAN UNION s/pTf0 gs si so si sei se bi sTf0 gi so si slimf0 gi se 0 0 0 -4 3.57Td037gi sals bg a l(i sar sustainable investment shows up several weaknesses – both contingent and structural – in the EU sustainable nance framework, which could limit its e ectiveness in aligning capital ows with climate objectives.

THE SUSTAINABLE FINANCE DISCLOSURE REGULATION (SFDR) is aimed at making the sustainability content of nancial products more transparent but rests on a concept of 'sustainable investment' that is too broad and loosely de ned. Meanwhile, the EU Taxonomy Regulation has not yet become established as the reference framework for corporate bond issuance or sustainable investing. e EU also lacks a coherent framework for transition nance – or investment that is not yet classi ed as sustainable but that represents progress to greater sustainability – despite this being the market segment to which the largest volumes of investment will need to ow in the short to medium run.

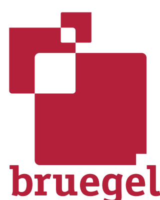
FIVE ADJUSTMENTS would make the EU sustainable nance framework more e ective at delivering the desired alignment of incentives. First, the taxonomy framework should be completed and clari ed. Second, the SFDR de nition of sustainable investment should be toughened. ird, the neutrality of the framework across capital market instruments, in particular debt versus equity, should be ensured. Fourth, a dedicated framework for transition nance should be developed. Finally, formal sustainable and transition labels for nancial products should be introduced.

THIS APPROACH would make the sustainable nance framework more easily applicable to all kind of companies and all types of capital market instruments, regardless of whether they limit the use of proceeds, and it would be naturally extendable into a framework for transition nance and into a transparent sustainability labelling regime for nancial products.

Disclosures: Silvia is the author of High Level Group (2023), which is referenced in this paper. She works at Algebris Investments, a global asset management rm that is subject to EU sustainable nance regulation.

Recommended citation

Merler, S. (2025) '



Over the past seven years, sustainable nance has been the focus of a huge legislative e ort

activities qualify as environmentally sustainable – ie are 'taxonomy aligned'). An environmentally sustainable investment is de ned as *"investment in one or several economic activities that qualify as environmentally sustainable"* as per the taxonomy.

e Sustainable Finance Disclosure Regulation (SFDR) – applicable since 2021 – introduces disclosure requirements for nancial market participants (FMPs) on the sustainability of the investment products they o er in the EU. FMPs must indicate in particular whether products *"promote environmental or social characteristics"*

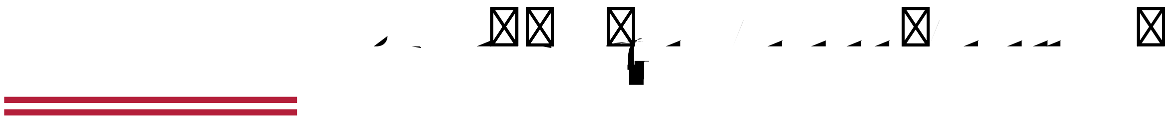
funding costs for companies that are more sustainable (or that turn to funding instruments with embedded sustainability).

However, if FMPs do not intrinsically care about sustainability, increased transparency is unlikely to be enough to alter incentives in their nancing decisions. is is where the other components of the sustainable nance framework come into play. Under the so-called MiFID II Directive (2014/65/EU; Markets in Financial Instruments Directive), rms that provide nancial advisory or portfolio management services must ask their clients if they have a preference for sustainable investment and must follow those preferences in advisory and allocation[3].

e combination of sustainability preferences rules with SFDR disclosure requirements aims at ensuring that *if*

especially for smaller companies. e availability of granular data on the taxonomy-alignment of bank loans is very limited, but anecdotical evidence suggests the volume of taxonomy-linked loans to be small. According to PSF (2024), based on a sample of 4000 SMEs, *"over the last two years, 9–10% of SMEs have obtained a green or sustainability-linked loan from a bank"*

their assets in sustainable investments with an *environmental* objective. On average, however, these funds only commit to invest 3 percent of their assets in taxonomy-aligned activities, and the median commitment is zero (Figure 4, right panel). Among Article 9 funds that commit to invest more than half of their assets in environmentally sustainable investments, the average taxonomy commitment rises to 5 percent, but the median commitment remains at zero[7].



percent of output and 3 percent of gross value added (GVA)[8] in 2022). e dominance of utilities in taxonomy-aligned green-bond issuance is due to the relatively fewer require-

Regulatory uncertainty helps explain the scepticism of nancial market participants (FMPs) about committing to taxonomy-aligned investment (section 4.1). As long as corporates remain reluctant to embrace the taxonomy, investors will likely remain cautious on their taxonomy commitments. But there are other reasons why the framework may remain unappealing for investors in the immediate future.

Source: Bruegel based on data from Bloomberg, as of November 2024. Note: N.A. indicates companies for which the share of taxonomy-aligned revenues is not known.

purpose (in that they are general funding instruments) but the *cost* of that funding increases if the company misses some pre-determined sustainability targets.

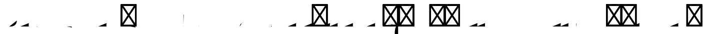
ese instruments can be a powerful driver of the transition, but their e ectiveness depends on the level of ambition of their targets and the size of the penalty for missing them. Between 2021 and 2024, companies incorporated in the EU issued a total of €118 billion in SLBs, 62 percent of which had at least one greenhouse-gas emission reduction target. For the majority of greenhouse-gas-linked SLBs, targets covered only part of the companies' emissions and the penalty for missing targets tended to be small (Merler, 2024). In a still non-standardised and relatively opaque market segment, the risk is signi cant that companies will lower the ambition of SLBs targets to reduce the likelihood of being caught o guard. Europe is the largest market for behaviour-based debt instruments and the most advanced jurisdiction when it comes to regulating corporate transition targets, so it should reap the potential of an e cient SLB market by introducing an EU standard for SLBs, similarly to what it did with the EU Green Bond Standard.

In June 2023, the Commission published a recommendation on *"facilitating nance for the transition to a sustainable economy"*, in which it stated that transition nance should be understood as *" nancing of climate and environmental performance improvements to transition towards a sustainable economy, at a pace that is compatible with the climate and environmental objectives of the EU"* (European Commission, 2023). e recommendation also listed four examples of investments compatible with this de nition:

a.

Adjustments can be made to the EU sustainable finance framework to make it more effective at delivering the desired alignment of incentives. At the core of our recommendations is therefore the creation of a clear, transparent and dedicated framework for transition finance – which is currently not properly defined in the EU legal framework.

As discussed in section 4.2, the binary nature of the taxonomy (sustainable/not sustainable) makes it complex to use the taxonomy as a tool for transition finance, likely explaining why the taxonomy does not yet appear to be widely used by corporates in bond issuances, or by investors for sustainable investing. European Commission (2023) stressed that the taxonomy should be used not just as a reporting tool, but as a planning and strategy framework. For this to happen, the taxonomy should be completed to add all economic activities that can contribute, even marginally, to environmental sustainability. In addition, introducing a 'traffic light' structure, with an amber category for transitional activities and a red category for harmful ones, would increase transparency and boost the usability of the taxonomy as a transition-finance framework (High Level Group, 2023).



As highlighted in section 1, confusion persists on what 'sustainable investment' means under EU law. The Taxonomy Regulation and SFDR define it differently, prompting ESMA (2023a) to issue a clarification. Yet, the reasons for concern over the definition remain unaddressed –

As discussed in section 4.4, the mismatch between the definition of sustainable investment under SFDR and under the taxonomy risks introducing an implicit bias against equity capital – because the taxonomy alignment of an equity investment necessarily depends on the entity-level taxonomy alignment of the investee company, rather than on the alignment of specific projects being funded. To be truly effective, the EU sustainable-finance framework should be applicable in a neutral way across all capital-market instruments.

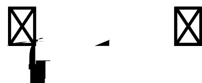
One option to achieve this would be to rescale the taxonomy-alignment of green bonds by a measure of the overall taxonomy alignment of the company, in order to avoid the paradox that we describe in section 4.4 and to preserve neutrality of the framework across capital market instruments. However, this would completely defeat the purpose of green bonds, which is to

the sustainability threshold to increase as a consequence. ere would seem to be no obvious reason to 'force' transition products to divest from companies that have switched from transitioning to sustainable. Sustainable and transition investments should rather be allowed to coexist within the portfolios of transition products, as long as transparent disclosure rules are set around respective shares in the portfolio.

Over the past decade, the EU has set ambitious climate goals, which will require massive investment. Sustainable nance must play a major role and much regulatory activity has gone into building a framework to reorient capital ows in line with climate goals.

However, this e ort is not yet delivering the desired results. e core pillar of the EU sustainable nance framework – the taxonomy – has not established itself as a reference framework in corporate funding or sustainable investing. While legislative uncertainty has played a role in this, and takeup of the taxonomy may improve in the future, there are also structural reasons to be sceptical that this will happen. e most compelling of these is the lack of a coherent EU framework for transition nance.

e EU sustainable nance framework should be made more easily operational and more e ective at delivering the desired alignment of incentives across the real economy and the nancial sector. e changes we propose in this Policy Brief would be instrumental in achieving that result. e framework we propose would have the bene t of being applicable to all companies, but most importantly, it would be neutrally applicable across all capital-market instruments and easily extendable into a framework for transition nance and a transparent labelling regime.



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