Christa Hainz, Johann Wackerbauer and *Tanja Stitteneder*

Economic Policy Goals of the Sustainable Finance Approach: Challenges for SMEs*

Fighting climate change and promoting sustainable development are currently among the most important social, economic and political concerns. At the European level, these issues have long since come to the fore, not least in the European Green Deal. By presenting the EU Action Plan on Sustainable Finance, the European Commission has also assigned a key role to the financial system. The aim of the Action Plan is to regulate the financial system in such a way that it is able to contribute to sustainable development. All member states are required to implement the EU Action Plan; national governments may be even more ambitious. The German government, for instance, has set itself the goal of establishing Germany as a leading center for sustainable finance. It was against this background that the Federal Government's Sustainable Finance Committee was set up. The German Federal Financial Supervisory Authority (BaFin) has already begun to integrate the issue of sustainability into German banking supervision.

While the need for a more sustainable economy is hardly disputed, opinions differ on the question of what measures should be taken. Numerous measures have been discussed in the EU and on the national level – some of them controversial. As in many European countries small and medium-sized enterprises (SMEs) are of particular importance, the impact which the new regulations have on the financial sector and ultimately on SME financing is crucial, albeit hitherto little discussed.

* This article is a summary of the study "Sustainable Finance – Eine kritische Würdigung der deutschen and europäischen Vorhaben," conducted by the ifo Institute on behalf of the Chamber of Industry and Commerce for Munich and Upper Bavaria (Fuest, Hainz, Wackerbauer, and Stitteneder 2020), and an updated translation of Hainz, Stitteneder, and Wackerbauer (2020).

THE EU ACTION PLAN AND MEASURES AT EUROPEAN LEVEL

The objectives of the EU Action Plan can be put into three categories (European Commission 2018):

1. Directing capital flows into sustainable investments;
2. Managing financial risks arising from environmental and social issues;
3. Promoting transparency and a long-term view in financial and economic activity.

The EU Action Plan comprises a catalog of ten measures; its aim is to anchor sustainability in the financial sector. The taxonomy forms a central instrument for assessing the sustainability of an economic activity and can be considered the core of the Action Plan. It creates a uniform definition of sustainability as a basis for assessing green financial products. The taxonomy classifies certain economic activities as sustainable. The aim is to lay down criteria for green financial products, to ensure the necessary market transparency for investors, and to avoid the problem of 'greenwashing'.

In addition to developing the taxonomy, the Action Plan introduces an EU label for green financial products, establishes sustainability obligations for asset managers and institutional investors, strengthens the transparency of firms regarding their environmental, social, and governance (ESG) policies, and considers adding a 'green supporting factor' in EU prudential rules for banks and insurance companies (European Commission 2020a).

For economic activities to be considered environmentally sustainable, they must not only make a significant contribution to at least one of the six environmental goals, but they

Christa Hainz

is Deputy Director of the ifo Center for International Institutional Comparisons and Migration Research, focusing on institutions and financial intermediation.

Johann Wackerbauer

is Senior Researcher of the ifo Center for Energy, Climate and Resources. His main areas of expertise are environmental economics, environmental policy and eco-industry.

Tanja Stitteneder

is Project Specialist at the ifo Center for International Institutional Comparisons and Migration Research. Her work focuses mainly on EU policy and international relations.

must not harm the other environmental goals ('Do no significant harm' – DNSH). They also have to ensure a minimum level of protection for employees (TEG 2019a).[1] The taxonomy defines technical screening criteria for the first two items in particular. Ideally, these thresholds must be met for an activity to be considered sustainable.

OBJECTIVES AND DISCUSSION OF MEASURES

In the following we discuss how the proposed measures can contribute to achieving the objectives presented above.

Goal 1: Channeling Capital Flows into Sustainable Investments

Substantial investments are needed to finance the transition to greater sustainability. In the EU, it is estimated that EUR 260 billion of additional investment will be needed annually for climate action alone (European Commission 2021). Investing in sustainable economic activities avoids creating new assets that are, for instance, exposed to transition risks and devalued by political decisions to combat climate change.[2] It is estimated that currently over 40 percent of pension fund and mutual fund equity portfolios could be affected by transition risks (Monasterolo 2020).

To steer capital flows more toward sustainable investments, sustainability is being specified as a criterion in investment advice and lending. This leads to new distinctions being made in financing options and conditions. This could mean that sustainable firms are better able to finance themselves than less sustainable firms. In relative terms, therefore, the cost of capital increases for less sustainable firms and firms that do not (or cannot) adequately demonstrate their sustainability, and their profitability decreases. This is reflected in their investment and production decisions. This is one way in which the criterion of sustainability has an impact on the real economy via the financial market.

Previous empirical studies have looked at investment performance and credit conditions. For example, a meta-analysis that merges the results of 2,000 studies concludes that the vast majority of studies find a higher return on sustainable investments. This is particularly true for investments in sustainable firms, but less so for investments in portfolios, such as mutual funds (Friede, Busch, and Bassen 2015). One might argue that investors do not require any additional incentives to put their capital into sustainable investments if they are more profitable. A recent study has, however, shown that retail investors, in contrast to institutional investors, reduced their investments in sustainable mutual funds after the outbreak of the COVID-19 pandemic (Döttling and Kim 2021).

Investigations into investment performance and lending are based on sustainability ratings, which firms opt for voluntarily. The performance of sustainable investments can be better for several reasons. One reason is that ESG scores capture firm characteristics that were not previously transparent and that (help) explain a firm's profitability. It could also be that more profitable firms opt for a sustainability rating anyway. This selection effect would not exist if all firms were required to provide a sustainability rating. In addition, financial market participants could increase the profitability of firms through their investment by exerting pressure on the management and (potentially) withdrawing their capital.

Furthermore, sustainable investments could have a positive externality on other investments if - through international coordination - the transition to a more sustainable real economy can be realized regionally at lower cost (Kittner et al. 2017). The underlying mechanism results from the learning curves observed in real terms for photovoltaics, wind energy, and battery storage – the key technologies of the energy transition. This externality should be addressed in a targeted and appropriate way, for example, by granting subsidies for investments and not for their financing.

Goal 2: Managing Environmental Risks

Involving the financial sector in environmental policy, and climate policy in particular, is relatively new. It is therefore important to clarify whether financial market products can be effective at all as a complement to a classic environmental or climate protection policy. The theoretical foundation of environmental and climate protection policy is that any environmental damage caused or to be avoided must be taken into account in the polluter's cost calculation. Therefore, the environmental policies of the European Union and the Federal Republic of Germany are essentially based on the 'polluter pays' principle. The consideration of external environmental costs changes the cost structure to the disadvantage of environmentally harmful production and consumption methods and in favor of more environmentally friendly alternatives. In the case of price-elastic demand functions, this results in a decrease in demand for the environmentally harmful alternative and an increase in demand for the more environmentally friendly alternative. Production is adjusted and, in the longer term, investment is redirected. In other words, the real economic adjustment to the use of environmental policy instruments already achieves the desired steering effect, and the financial adjustments in the corporate sector follow the real eco-

[1] The six environmental goals are: climate change mitigation, climate change adaptation, sustainable use and protection of water and marine resources, transition to a circular economy, waste prevention and recycling, pollution prevention and reduction, and protection and restoration of biodiversity and ecosystems (TEG 2019a).
[2] Transition risks are risks arising from the transition to CO_2-free economic structures.

nomic ones. This raises the question of whether the financial sector has any role to play at all in environmental and climate protection policy.

One possibility is that sustainable financial investments serve as a support for traditional environmental policy. Such support may be necessary if the effect of the environmental relief brought about by the policy instruments is in the desired direction but the envisaged environmental target, for example the reduction target for greenhouse gases, is not fully achieved. In this case, intervention in the financial sector with criteria for 'green financial products' could, in theory, be supportive. It is unclear what contribution this would make to the environmental objectives, as the level of demand for green financial products would remain uncertain. The reduction target would be certainly achieved if all emitters of greenhouse gases were included in the EU emissions trading system. However, in this case it would no longer be necessary to support the effect through financial market regulation.

Goal 3: Promoting Transparency and a Long-Term View in Economic and Financial Activity

This objective of the EU Action Plan addresses a central problem of corporate governance. If ownership and control of a firm are not in the same hand, the different levels of information among the parties involved (asymmetric information) can create incentive problems. This means that the manager's goals do not always coincide with those of the owner. Incentive problems can arise, for example, when a manager's plans have a shorter time horizon than the owner's. The EU Action Plan addresses these two problems. On the one hand, information asymmetries are reduced through greater transparency. On the other hand, prolonging the decision-making time horizon aims at promoting the long-term nature of economic activity. It is important to note that incentive problems play a much greater role for large firms financed via the capital market than for smaller firms that are owner- or family-run.

The Non-Financial Reporting Directive (NFRD) extends the reporting obligations of firms to non-financial aspects to strengthen the transparency of firms in terms of their sustainability. Since 2018, larger firms have to report on such topics as environmental protection, social responsibility and governance. Going forward, the reporting obligations will be extended to include climate-related information, following the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD) established by the G20 Financial Stability Council (European Commission 2020b). The taxonomy also requires these firms to report on the sustainability of their economic activities (European Commission 2019).

A broad information base creates an awareness of the problem in firms and enables them to better manage their sustainability issues. At the same time, there are data collection costs that firms will only be prepared to incur if the resulting benefits are higher than the costs – unless they are obliged to do so. For investors, increased transparency certainly helps when it comes to assessing the sustainability of a potential investment. The extent to which transparency promotes long-term decision-making depends on the ability of investors to expand a manager's decision-making horizon. If the investor has a longer decision-making horizon than the manager, it is important how much influence the investor has on decision-making in the firm. Here too, more information should prove to be helpful. Ultimately, it is the actually available corporate governance mechanisms and, of course, the financing structure of the firm that will determine how much influence investors can actually exert. However, if it is uncertain how sustainability criteria will develop and whether the firm can fulfil these criteria in the long term, capital providers, especially banks, will also be affected. One possible reaction could be that they shorten their investment horizon, which could, for example, lead to offering loans with shorter maturities.

Politicians can also play a role in longer term decision-making. By establishing reliable framework conditions and regulatory requirements that can be foreseen in the long term, economic policy can reduce the level of uncertainty for firms and thus help with expectation management. For firms, this reduces the risk of investing in assets that might lose much of their value as a result of political decisions. Reducing uncertainty creates incentives for sustainable investment.

CHALLENGES FOR SMES

The sustainable finance approach poses challenges for SMEs in two respects. First, the new regulatory requirements must be in reasonable proportion to the firm's size. Second, they must take into account the special nature of the main bank relationship that many SMEs have.

Proportionality of Requirements and Firm Size

According to the EU Action Plan, sustainability disclosure is voluntary for firms. This means that SMEs are able to opt out – especially since financing via the capital market is of less relevance to them. However, firms that are subject to the Non-Financial Reporting Directive, i.e., public interest entities with more than 500 employees, are obliged to disclose the sustainability of their economic activity according to the taxonomy. However, from the taxonomy the extent of this obligation and whether it also applies to the supply chain is unclear. If SMEs that are suppliers of firms subject to the disclosure requirement were also obliged to report, they would be disproportionately affected by these costs, as they do not increase in proportion to the firm's size but include a considerable fixed component.

Since SMEs act as both suppliers and buyers within supply chains, there are multiple points at which they would be affected by this requirement. Even the taxonomy has identified proportionality as an issue (TEG 2019b). Policymakers could support SMEs by applying the disclosure requirement only above a certain firm size or by compensating firms financially for the effort they are required to expend. In addition, all the options for making relevant information publicly available should be exhausted, for example, concerning emission levels, to minimize the costs of non-financial reporting.

The Special Nature of the Main Bank Relationship

According to the Non-Financial Reporting Directive, major banks but also the central institutions of savings banks and of cooperative banks must disclose the sustainability of their investment and loan portfolios. This means that banks have to gather this information for individual loans (BaFin 2019). In this context, it should be noted that the main bank relationship is of great importance to many firms and to SMEs in particular. A survey for Germany shows that, on average, a firm has maintained its relationship with its most important bank for 29 years (Hainz and Wiegand 2013). Both parties build a reputation as a reliable negotiating partner through this main bank relationship, which can be considered as an implicit contract. This implicit contract creates an incentive for firms to disclose information that is relevant to the bank's credit assessment. With respect to the new regulations the question is to what extent and in what form the bank is required to record information on sustainability risks and what effort this entails for both the bank and the borrower.

POLICY RECOMMENDATIONS

With climate change, the goal of a more sustainable economy is increasingly the focus of the public debate. The EU Action Plan on Sustainable Finance attributes a crucial role to the financial system. It is widely accepted that a sustainable economy requires sustainable investments. However, how this can be implemented and what exactly is meant by sustainability is currently heavily debated. Since SME financing plays a particularly important role in many European countries, it is all the more important to integrate the perspective of SMEs into the design of the EU Action Plan. This is specifically expressed in the following recommendations:

- Policymakers should create incentives for the transition to a more sustainable economic system, by establishing reliable framework conditions.
- As intended, the application of the taxonomy to financial assets should be neither mandatory nor applied to all financial products.
- Proportionality for SMEs is crucial. Additional information requirements place a disproportionate burden on SMEs. Therefore, SMEs should be exempted from reporting and disclosure requirements or relieved of the additional costs.
- Information should be allowed to flow within the main bank relationship without any burdensome documentation requirements, so that the full advantage of the long-term main bank relationship can unfold.

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