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The financial and non-financial challenges of the Green Deal

The Green Deal and the coronavirus crisis

This article has been prepared before the health crisis and the dramatic impact it has on the European and the world economies.

But the Green Deal has not be made obsolete by this new crisis, it is only a new challenge for it. In the coming months, the priority will be to combat this crisis and support the economy. But, as we argue in part III of the article, the ambitious medium-term Green Deal project should not be forgotten. This crisis shows also the need to pursue a structural rebalancing of our economies in favour of ESG criteria. The Green deal should be inserted in the measures to support the recovery of the economy in order to put it on the necessary trend more respectful of a good life on our planet.

Finally, we are of the opinion the Green Deal should not be considered as a priority that should follow the relaunching of the economy, but rather as the indispensable set of ESG targets required to reduce risks in the EU, be they climate or biodiversity related.

The Green Deal in a nutshell

The President of the new European Commission, Ursula von der Leyen, has launched an ambitious programme of transition to a low carbon and circular economy, called the European Green Deal. It is the first priority of the Commission's five year-mandate and its first goal is for the European Union to be carbon neutral by 2050. This programme and this goal have generally been well received by the European Council, the European Parliament, the experts and public opinion, although some green militants have criticized it for not being ambitious enough.

The financial and non-financial challenges of the Green Deal

To reach this goal, the Communication of the European Commission on the Green Deal draws a very impressive list of actions, including EU legislation and EU budget proposals, but also actions by member states and the private sector.

To finance this ambitious programme, the Commission proposes to mobilise the quasi magical figure of €1,000 billion in the next 10 years. The volume of finance necessary for reaching the new ambitious targets is of course an important challenge and, even if there is not a reliable estimation at this stage, much more than €1,000 billion is needed from the private sector alone.

This high volume of private funding could probably be available if there was a framework of regulations, incentives and support which would both induce businesses and households to launch the necessary number of big and small "green" projects. These non financial challenges are more important than the financial ones and, if they are met, the financial sector could probably bring the high volume of funding which is necessary.

1. The financial challenge: the €1,000 billion of the Green Deal and the need for a higher volume of private finance

1.1 The €1,000 billion of the Green Deal for the period 2021-2030, as proposed by the European Commission, are a rather complex addition of EU budget funds, national budget funds, public development banks and private finance "triggered" by public guarantees, which in a nutshell is the following :

- EU budget funds of around €500 billion, including €100 billion or more for the Just Transition Fund, which will help the most impacted regions, like the coal regions in Poland; it is worth remembering that the EU 27 budget (without the UK), currently under discussion for 2021- 2027, is roughly 1% of GDP (around €135 billion per year);
- Member states' budgets for €100 billion;
- €300 billion from private funds "triggered" by public guarantees, like in the Juncker Plan and its successor "InvestEU";
- €100 billion from international financial institutions, EIB and national public development banks.

1.2 Much more is needed from the private sector

The €1,000 billion over 10 years, i.e. €100 billion per year, will be far from enough to finance the needs linked to such an ambitious programme of energy transition and environmental protection.

The estimation by the Commission is that a supplementary gap of €160 billion per year has to be financed by the private sector alone, but this gap is probably undervalued.

The estimation of a total gap of €260 billion was already linked to the Sustainable Development Action Plan introduced in 2018, for which the amount of financing needed in transport, energy and circular economy reached €530 billion, of which €270 billion was, on average, already financed in the preceding years.

The level of ambition of the Green Deal is significantly higher compared to the previous action plan. For instance, the target for the level of emission of greenhouse gas by 2030 has been increased from -40% to between -50% and -55%, an increase in effort of at least 25%. The total amount and the additional need will have to be significantly increased. A conservative estimate is to increase the total needs by 20% at €110 billion. The gap will also increase by €110 billion to be financed by the private sector.

In conclusion, while there is no reliable estimate of the financial funds needed from the private sector alone at this stage, it is probably at least €2,700 billion over the next 10 years in addition to €1,000 billion proposed by the Commission.

1.3 The recent known figures of investment in energy transition are disappointing

The last Investment Report of the EIB, published in November 2019, gives figures which are disappointing: in 2018, the EU invested only 1.2% of its GDP (€158 billion) in the fight against climate change, less than in 2017 and a little less than the USA (1,3%).

This figure is also to be compared to the goal of €390 billion per year for energy and transport in the Commission's document linked to the action plan of 2018.

1.4 Why the financial challenge can still be overcome

Private financial funds directed to "green" financing are rising each year.

The green bonds market, for instance, reached a record volume in 2019, with $278 billion of bond issues, 40% of which in the EU ($110 billion). Most of the pension funds, insurers and asset managers have set ambitious targets for investing in green assets or green projects. What we hear from many European financiers is that they are more and more willing to invest to combat climate change and environmental deterioration.

Today, many financiers complain that they have money ready to be invested in green projects but that there are not enough projects to be financed.

The availability of funds is often not the most important challenge, as we can see if we take the example of the financing of housing. The volume of loans to households to buy their homes in the EU is very high, at more than € 500 billion per year. A probably very small part of these loans finance energy efficiency investment for homes (insulation, change of heating system...), although we do not have precise figures up to now. More importantly, we know that the lack of energy efficiency in residential housing is one of the important weaknesses in the EU in the fight against climate change.

Let's imagine that as soon as a household wants to buy a home which is not energy efficient enough (probably 80% of the market), a part of this loan will also finance measures leading to energy efficiency (insulation, modernisation of the heating system, solar roof, etc). Thus, an important volume of "green financing" would take place. The constraints here are linked more to the information to be given to the households, good and neutral advice being offered to them, and also incentives, including regulatory constraints and fiscal inducements.

There are still improvements to be made in banking and financing regulation to stimulate green finance and remove some major obstacles in the way of a large increase in private green finance (cf. II) 5 § below). The EU action plan on sustainable finance has to be implemented to deliver notably a helpful taxonomy and necessary "green transparency" and sharing of data, but the existing banking and financial regulation must also be modified because it discriminates too much against long term finance, as has often been shown at Eurofi meetings.

2. The four main non-financial challenges of the Green Deal

It seems that there are four challenges for a successful Green Deal and the necessary mobilisation of private finance. We must:

- Get the political and popular support for the most difficult decisions;
- Set the necessary targets and incentives (including constraining regulation) for businesses;
- Develop a specific programme for the energy efficiency of residential housing;
- Engage with third countries to induce them to implement the Paris Treaty and to avoid carbon leakages.

2.1 Get the necessary political and popular support for the necessary legislation and good choices in public finance

What is needed first is to pass the necessary legislation in all sectors concerned, with ambitious but achievable targets (for instance in transport), and regulation to reach these targets. The programme of the Commission, which will be implemented in detail in the coming months and years, seems a priori in line with this objective.

Then good choices must be made in public finance at the EU level, but also at the national or regional level. There is a need to support the people and regions suffering from the transition, to support research and the most risky projects, and to create the necessary incentives, particularly for households. EU member states should also cut the subsidies to fossil energy and increase carbon pricing (which will also increase public resources).

Finally, the implementation of the Green Deal must be ensured by active monitoring, support of the member states that need it, but also by putting the necessary pressures on lagging member states.

Since the announcement of the Green Deal, the Commission has had good general support from the Council, which agreed (with the exception of Poland) on the goal of carbon neutrality by 2050. The European Parliament will also support this goal, but tough choices remain ahead, including on the next multiannual budget for 2021 2027.

2.2 Provide businesses with good incentives in order to get a much bigger number of projects to be launched through:

- Regulation bringing new targets and higher standards, especially for industry, transport and housing;
- Public funds and private-public partnership where necessary (the EU battery project, for instance);
- Improving data and experience sharing within the different economic sectors and the financial sector.

2.3 Develop a specific and massive programme for the energy efficiency of housing through a specific partnership between public actors and the financial sector, providing incentives, but also adequate advice to households.

For households, measures to improve the energy efficiency of the home generally have only a long term financial interest and are difficult to sort out. For instance, is it better to insulate the windows, walls, doors or roof, or to change the heating system? Is it safe to have a solar installation on a roof? Which of these measures will allow a good certificate of energy efficiency, etc? The projects are also often complicated by the legal framework.

Public actors, at national and/or local level, should commit themselves to implement clear energy standards, simplify legislation as much as possible to facilitate these investments, provide incentives (fiscal incentives), and provide good and neutral advice to households through public agencies or monitored by them.

The banking sector should green large parts of the regular housing loans. Each household applying for a loan to acquire a home which is not energy efficient should receive a proposal from the bank to also finance energy efficiency measures targeting levels of energy efficiency rewarded by the adequate certificate. They should also ensure that the household can benefit from adequate and neutral advice.

This banking sector effort should be supported by a "green factor" (which is also justified on the prudential side, as shown by many studies). There is also the need to improve and simplify the regulatory framework regarding securitisation by creating a "green securitisation" regime, which could attract long term investors eager to invest in green products with regular cash flows. Such a framework should benefit the loans to transition projects, like households' home adaptations and households and SMEs to buy electric vehicles.

2.4 Engage with third countries, because fighting against climate change is a global fight and there cannot be free-riding countries:

The EU has made more progress in fighting climate change and protecting the environment than most other countries. Accelerating this progress through the Green Deal is necessary, but will be useless if it is not followed by all the world regions.

The EU should induce international partners to implement the Paris Treaty, including leading by example, exporting standards and providing financial support for the poorest countries.

It is also necessary to avoid carbon leakages of countries which will not comply with the Paris Treaty by building, as proposed in the Green Deal, a "carbon adjustment" mechanism at the EU border, at least for the goods of the most energy intensive industries.

2.5 The private financial sector will have also to increase its efforts and play, for instance, a bigger role to redirect financial flows from fossil and polluting activities to "green" activities and further innovate regarding financing tools.

The financial sector has started to engage with greenhouse gas intensive industries. Some banks and long term investors have, for instance, decided to stop financing coal, but these efforts and the pressure on the users of fossil fuels should be further increased. At the same time, the financing of the transition of the polluting industries to the circular economy should be increased.

These efforts should be supported by the implementation of the action plan on sustainable finance. The development of a clear taxonomy is welcomed, provided it allows the necessary transition. "Green transparency" is necessary to put pressure on the laggards in the financial sector, but also to trigger the sharing of data, the development of models and scenarios, and thus progress in the knowledge gained and choices to be made.

As already said, part of the financial regulation will also have to be improved, especially to alleviate the constraints weighing on securitisation and on long term investments, and to introduce a "green implementing factor" at least for "green loans".

3. The challenge of the economic outlook post Covid 19

The sanitary crisis created by Covid 19 has become the number one concern in the world and has led to a strong and global decrease of production and consumption.

This economic crisis is of a new type and its effects are correlated with the duration of the sanitary crisis.

The governments of countries impacted by the crisis have taken measures to support firms and their employees. Central banks are also injecting liquidity to refinance the debt of households, firms and the public sector. These measures are providing temporary support pending the end of the sanitary crisis.

This pandemic, like all pandemics in history, will hopefully stop in some months, opening the way for recovery.

Given the very strong impact of the crisis, this recovery will need to be supported by public finance and continuous central bank intervention as in 2008-2009.

The Green Deal should be an important part of the recovery programme, based on a partnership between public authorities and the private sector.

Of course, there will be some pressing short term financing needs to avoid bankruptcies and massive unemployment. But, in parallel, a priority will be to encourage investment, as it is the only way to achieve a robust recovery in the medium term. In this respect, energy and environmental transition investments must be a central part of this new Marshall plan that Europe needs. The increase in the intervention of the central banks, for instance, should support "sustainable" finance.

We should also not forget the three "sustainable" lessons that we have to draw from the Covid 19 crisis:

- First, this crisis illustrates the strong links between our present development model and the increasing frequency of global sanitary crises. Often originating from animal sources, the spread of global pandemics cannot be detached from human actions such as deforestation, rapid urbanisation and the illegal trade of endangered species;
- Secondly, the excessive dissemination of production and the too strong dependency of Europe on mainly China, but also India, has to be reduced; this will increase employment in Europe and decrease the need for transport of goods and people;
- Thirdly, there are some positive consequences of the crisis. Some are temporary, like the strong decrease of pollution and CO_2 emissions. Others will stay, like a bigger usage of teleworking and teleconferences, which will reduce the need for transport. The decrease of the price of oil also offers the possibility for public authorities to increase the price of carbon, which will help their finance and bring useful support to the energy transition.

In this context we can assert that it is not the Green Deal that should be considered as a priority that should follow the relaunching of the economy, but rather as the indispensable set of ESG targets to be defined in order to reduce risks in the EU, be they climate or biodiversity related, and support the transition toward a sustainable economy, the importance of which is stressed by the current sanitary crisis.

Provided that the financing of the investments prioritised by the Green Deal will be made more difficult, at least in 2020, this year and 2021 should be leveraged to put in place the necessary framework targets and subsequent regulations to support and incentivise a strong development of projects in 2021 and the years after.

Private finance will have to take the bigger share of the financing needs, as long as the right framework is in place (cf. part II above) and if there is a good public-private partnership, sometimes on very concrete details like advising households for the energy efficiency of their homes, with the common goal of putting the building of an economy more respectful of good life on our planet at the heart of the recovery .

Public authorities and some private firms have already signalled their support to pursue an ambitious policy of energy and ecological transition. In the communiqué of the European Council of 26 March, devoted to measures to fight the pandemic but also to support the EU economy, there is the following paragraph:

"The urgency is presently on fighting the Coronavirus pandemic and its immediate consequences. We should however start to prepare the measures necessary to get back to a normal functioning of our societies and economies and to sustainable growth, integrating inter alia the green transition and the digital transformation, and drawing all lessons from the crisis. This will require a coordinated exit strategy, a comprehensive recovery plan and unprecedented investment. We invite the President of the Commission and the President of the European Council, in consultation with other institutions, especially the ECB, to start work on a Roadmap accompanied by an Action Plan to this end."

In the last weeks, there have been many public statements about the priority to be given to a sustainable agenda in the post-Covid recovery programme. Most of them, coming from EU and national politicians, NGOs, but also private firms have been in favour of this priority.

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In 1815, after the end of the Napoleon era, France was ruined. The Minister of Finance, Baron Louis, said to his King and his Prime Minister "***Faites de la bonne politique et je vous ferai de la bonne finance***". This recipe is probably the same today, where the "good policy" to overcome the crisis, has to include an implementation of a robust strategy to deliver the energy and environmental transition that we need.

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