



**SUSTAINABLE
FINANCE LAB**

Policies for Sustainable Finance to Fund the Climate Transition

A report by the Sustainable Finance Lab (Sweden)
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Executive Summary

The saying that ‘money rules the world’ captures an important truth about how finance and investment flows determine the future of our society. In order to meet the challenges posed by climate change, there is a great need to redirect investments from economic activities that pollute the environment (such as fossil fuel extraction) into more sustainable activities and green projects (such as recycling and renewable energy). This report explores ways in which this can be successfully achieved. More specifically, the report seeks to answer two overarching questions: **1. What role does the financial sector play in achieving society’s climate goals and in financing the climate transition? 2. How can the government of Sweden influence the financial sector so that capital is increasingly directed towards more sustainable activities?**

The report is authored by the Sustainable Finance Lab, a multidisciplinary competence centre established to enhance the ability of financial markets to contribute towards sustainable development. We have surveyed public policies for sustainable finance in both Sweden and the EU, and critically assess these policies on the basis of a broad range of academic research. We have also surveyed private sector actions, and how the private and public sector together develop sustainable finance practices. We draw on this critical analysis to put forward **recommendations concerning how the Swedish government should act to promote investment in the transition to a climate friendly society.**

We have identified three overarching areas in which political action is most needed:

- (1) **Market Functioning:** In order to harness the potential of financial markets to ‘on their own’ allocate resources efficiently, there is a need for policies that address central market failures and frictions that are barriers to more sustainable investments. The Swedish government should promote policies that enhance financial markets’ functioning in these regards, in particular their ability to recognize investors’ preferences for sustainable investments and to reliably allocate these investments towards sustainable companies and green projects that support climate policy objectives.
- (2) **Prudential Regulation:** Delegated authorities such as Riksbanken and Finansinspektionen play an important role in overseeing financial markets, with regards to the ‘prudential’ goals of price and financial stability. But this work now needs to be updated in order to give greater attention to climate-related risks and the role of financial markets for the climate transition. The Swedish government should review the mandates given to the relevant authorities and enact public policies that increase the alignment between prudential and sustainability goals.
- (3) **Directly Promotional Activities:** The public sector can also play a more active and direct role in redirecting capital flows towards sustainable companies and projects, for example through public investments or credit guarantees. Such promotional activities are necessary to spur new markets and to support new solutions that private investors are unable or unwilling to finance. The Swedish government should continue to ramp up its

activities that aim to swiftly and directly revert incentives away from high-carbon investments and towards more sustainable and long-term financing initiatives.

More generally, while there is a need for a multitude of policy interventions, there are gains from ensuring better alignment between public institutions such as the government, central banks, and supervisory agencies. Moreover, the degree of international integration of financial markets requires policy coherence at both national and international levels. The policy areas should however not be understood as being mutually exclusive or separate. Certain recommendations put forward will pertain to and concern more than one policy area.

Strengthening sustainable market functioning

Recent years have seen much activity pertaining to the ‘EU Action Plan on Sustainable Finance’: including such elements as disclosure requirements, benchmarks and the ‘EU taxonomy of sustainable activities’. While it is easy to be overwhelmed by these initiatives, it is important to take a step back and put them into perspective. The bulk of the EU Action Plan consists of what we call market functioning policies and should therefore be seen as rather “light”, although often necessary, regulations of otherwise market-based products and initiatives.

The objective of market functioning policies is to target the market failures and frictions that are barriers to more sustainable investments, such as information asymmetry, myopic investment horizons, and investment under uncertainty. It is vital to address these in order to harness the great potential of financial markets to allocate resources in efficient ways, although it is naive to think that market functioning policies on their own are enough to support a swift and strong transition towards a more sustainable society. Our more precise recommendations in this context are organized along two main themes, which are harmonizing global standards and aligning regulatory frameworks.

Harmonizing global standards on sustainable finance

The Swedish government should continue its support of the development and implementation of global sustainability standards through international organizations, but can potentially play a more active role in areas in which Sweden has particular strengths. In recognition of Sweden’s limited size and independent influence, it is more efficient to engage with the establishment of sustainability standards through international organizations such as the EU, the UN, the IMF etc. Sweden is already engaged in several such initiatives. In the future, the government may decide to play a more active role with regards to certain areas of particular national competence, such as hydropower, paper, the development of construction materials, and public digital sustainability data, for the sake of contributing towards developing meaningful standards.

The Swedish government should task the Swedish competition authority to focus on unfair sustainability practices, so that the government can act swiftly to prevent possible adverse effects of international sustainability standards on

Swedish industry. EU standard setting has a strong influence on the viability of products and business models of Swedish firms. To some degree, EU standard setting is a process where national interests are promoted by individual EU member states, and there is therefore a need for the Swedish government to promote Swedish interests in the EU standard setting process. To transition the financial markets towards sustainability, international sustainability standards should be promoted. Possible adverse effects of sustainability standards on Swedish businesses however can in turn be mitigated by the Swedish government intervening to remedy unfair sustainability practice internationally. The adverse effect of sustainability can also be mitigated by the Swedish government supporting competence development regarding how businesses can utilise sustainability to instead enhance their competitiveness.

The Swedish government should review its bilateral investment treaties (BITs) and renegotiate them where necessary to ensure they are aligned with climate policy objectives. BITs have become a concern as they can constrain host countries from implementing public policy. Under the Energy Charter Treaty, Vattenfall launched a 1.4 billion EUR claim against Germany over permit delays for a coal-fired power plant in Hamburg, which it won. It is unclear to what extent Sweden is using its BITs to constrain climate policy efforts overseas, but as Sweden is engaged in over 70 bilateral investment treaties and is through membership in the EU participant in various EU agreements it should review them to ensure they are not to the detriment of climate policy objectives.

The Swedish government should promote investment inflows by developing policy that supports foreign sustainable business development in Sweden. The comparative advantage to foreigners of investing in Sweden for sustainable business development should be made clearer. Ambitious climate policy signals for opportunities in carbon friendly economic activities and may spur investment inflows and the establishment of enterprises that need reliable and clean energy sources. The Swedish government can therefore support economic growth and climate policy objectives by supporting clean investment inflows, rather than exporting clean energy.

Aligning regulatory frameworks with climate policy objectives

Uncertainty arising from policy, and especially climate policy, are a key barrier to increased investment in the climate transition. The Swedish government should explore opportunities to reduce this uncertainty with policy that offers greater certainty on investment returns. There is a well-established positive relationship between the level of policy certainty facing investors and the levels of investments made. Flexible, price-based policy may have efficiency advantages, but these advantages should be considered along with the potential impact of reducing the certainty of investment returns and corresponding effects on investment levels.

The Swedish government should further employ coordinating agencies to promote sustainable finance and business models. Different regulations across disparate public policy areas could potentially come to work at cross purposes with each other. Potential gains in climate protection could therefore be realized by aligning regulatory

frameworks with climate policy objectives. As there is a need to develop sustainability-based business models, and great growth potential in the sustainability sector, government agencies such as Finansinspektionen, Swedish Energy Agency, The Swedish Environmental Protection Agency, The Swedish Agency for Economic and Regional Growth, VINNOVA, The Swedish National Board of Housing, Building and Planning, SEK, and more, should be employed in coordinated efforts to achieve greater development of the sustainability business ecosystem.

The Swedish government should enhance its capacity to swiftly evaluate, adapt, and implement better sustainable finance regulation. Sustainable finance regulation, and environmental and social regulation more generally, is developing rapidly. At the same time retail and institutional demand for sustainable finance products is growing. In this dynamic environment, there is a danger of policy mistakes that lead to adverse effect that can undermine legitimate efforts to finance the transition. For example, policy to support increased investment in the cleanest “green assets” may divert resources from “brown assets” that require investment to upgrade and convert to green. The conversion of ‘brown assets’ to ‘green assets’ may benefit sustainability objectives, but regulation may direct too little investment into this type of conversion. There is a need for a robust evidence base to evaluate the effectiveness of sustainable finance regulations to ensure a more efficient and cost effective transition towards sustainability. The government needs to develop a capacity to respond quickly to unsustainable finance practice because large amounts of financial resources may otherwise not lead to sustainability in the best way possible.

The Swedish government should actively promote regulation and standards that support the private sector’s international sustainable finance initiatives. Furthermore, Sweden should seek to lead the way internationally by, for instance, requiring more detailed sustainability accounting data from companies. Increasing efforts of private sector actors to transition financial markets towards greater sustainability need the support of matching international governing organizations, regulations, standards, etc. to be effective. Outstanding examples of such initiatives are the Glasgow Financial Alliance for Net Zero, and the International Sustainability Standards Board.

The Swedish government should deploy policy to ensure that smaller companies can access sustainable finance. This could be accomplished in part by supporting the development of simpler sustainability reporting standards for smaller companies. Current information frameworks utilized by financiers to guide their financing decision towards more sustainable businesses are distorted by systemic biases. These biases can undermine efforts to support financing of climate friendly projects. One source of bias is due to smaller companies often being unable to meet the informational demands being put to them by financiers. Increasingly elaborate sustainability reporting requirements impose costs that disproportionately affect small companies, as they lack the resources to meet these requirements. The effect being that smaller companies, which have been identified as an important driver of innovation, miss out on financing that would allow them to e.g. develop cleaner production.

Aligning prudence with sustainability

Prudential financial regulations aim to safeguard price and financial stability. As such they can be effective tools for the promotion of sustainable finance, since they have a direct steering effect which market functioning policies lack. Due to the fact that current prudential policies may actually impose obstacles to sustainable finance, there is presently a need to review the prudential framework and to develop new policies that better align prudential and sustainability goals. However exclusive reliance on prudential policies must be understood to be problematic as their primary function is to safeguard price and financial stability goals rather than sustainability per se.

Whilst the current prudential framework shows some concern for climate-related risks, there is a need to reconsider its focus on informational policies in favour of moving toward more structural and/or coercive policies. The Swedish focus has historically been on implementing informational rather than structural policies for the purpose of promoting sustainability, with some exceptions (mainly pertaining to how Riksbanken has chosen to exclude specific high-carbon investments from its own portfolio). The relevant authorities have mainly worked with improving the availability of information pertaining to the relationship between prudential and sustainability goals, and on giving non-coercive advice to market participants on how to e.g. reduce their exposure to climate risks. Seldom have more structural or coercive policies been employed, such as adjustments to capital or liquidity requirements or direct credit limits. This balance should be reconsidered in light of the seriousness and urgency of the threat posed by climate change to both price and financial stability.

There should be further dialogue to clarify the mandate of delegated authorities such as Finansinspektionen and Riksbanken as they relate to utilizing prudential policies to promote sustainable development. A reason why these authorities have not further employed structural or coercive policies relates to the interpretation of their mandates. Finansinspektionen has stated that it is not part of their mandate to raise or lower the capital requirements for certain types of exposures for the sole purpose of promoting sustainable development. Similarly, Riksbanken has stated that it accepts the “principle of market neutrality” which entails that state interventions are not allowed to distort competition without objective grounds. There is however valid criticism of this principle of market neutrality, since it does not guarantee efficiency in the presence of market failures. Policies for sustainable finance can consequently be seen as corrections of the market’s tendency to underestimate the risks inherent in brown investments and over-emphasize the risks involved in green investments. Such policies do not entail that a broader sustainability mandate must be adopted, as a failure to promote sustainable finance may jeopardize already established prudential goals.

Appropriate authorities should conduct investigations into the benefits and drawbacks of various structural policies pertaining to the Swedish context, including, but not limited to, proposals of adjustments to capital and liquidity

requirements. The Swedish authorities should rethink the balance of their prudential policies and move towards a greater usage of structural policies. At this point in time, it is difficult to determine the more specific policies of this kind which would be most suitable in the Swedish context.

The appropriate authorities should investigate the possibility of adjusting capital requirements through the introduction of a “brown penalising factor” to address concerns posed by climate-related risks to financial stability. Finansinspektionen was originally sceptical towards the government’s proposal to reduce the capital requirements for occupational pension funds investing in green infrastructure projects, on the basis that reductions in capital requirements could increase the risk for financial instability. Riksbanken has expressed similar concerns and argued that incentives to increase sustainable investment should be created in other ways. These criticisms are however only directed at the idea of a “green supporting factor” in capital requirements, i.e. a reduction in capital requirements for certain green projects. They do not pertain to the corresponding proposal for a “brown penalising factor”, i.e. an increase in capital requirements for certain brown projects. Relevant authorities should investigate this avenue to address concerns posed by climate-related risks to financial stability.

Employing directly promotional policies to develop sustainable finance

Directly promotional policies aim to ensure specific non-prudential goals by more direct state interventions in the market’s allocation of resources. These policies either shift resources directly to a specific use via public subsidies or investments, or they prohibit the use of resources for a specific use via quotas or other tools. Directly promotional investments can spur activity in new markets or support new solutions that, for various reasons, private sector investors are unable or unwilling to finance. Through directly promotional policies, governments can act swiftly and directly to revert counterproductive high-carbon investments, and support more sustainable and longer-term financing initiatives. An important challenge in this context is how to best organize or administer state interventions to ensure that they spur private sector investment rather than displace it. Direct public investment can be delivered via several channels, including the legislative channel, the monetary/supervisory channel, and the direct involvement channel.

Directly promotional policies should be implemented as robustly as possible, which entails that they most often will take the form of public mandates, assigned to delegated authorities. The effectiveness of directly promotional policies hinges on minimizing policy uncertainty through: a) clear selection criteria and careful communication, and b) to commit fully and without discontinuation to the transition pathway. This reduction of policy uncertainty creates trust and reduces uncertainty among market actors regarding the permanence of the policies, which is essential for market actors to make investments and organize their business. Directly promotional policies are therefore more likely to work if they are implemented as robustly as possible. They should not be perceived as “policies of the day” that may change as the political winds do. This could be reason to prefer administration by

delegated authorities rather than by the Ministry of Finance itself. As the mandates given to delegated authorities and public companies are announced in advance and cannot be changed too often, they are likely to minimize both types of policy uncertainties mentioned above.

The government should build its capacity for risk balancing between the private and public sector, for instance through procedures for swift development of enabling legislation and agency action. It is important to consider the distribution of risk-bearing inherent between the public and private sector in the different policies. The strongest argument in favour of directly promotional policies is that some of the risks involved in the climate transition can only be taken by the state. This is because some sustainability-related risks are too high for traditional market actors, which means that unless the state mitigates the risk, they will be reluctant to invest or develop their businesses in such a way. An important counterargument against such policies is however that the state may create a “moral hazard” scenario through shifting the risk to the public sector whilst guaranteeing repayments for investments made by private market participants. Moral hazard means that private actors intentionally engage in risky behavior because they know that any resulting losses will be incurred by someone else. To avoid such a scenario, directly promotional policies need to be implemented in a way that maintains a good balance of risk-bearing. Furthermore, there is a potential issue in giving a sustainability mandate to the public pension funds, as those who will bear the risk here are future pensioners instead of the public as a whole. The government should build their capacity to govern the balance of risk-bearing now, because this balancing will be of great importance in the future, not only because new investments and businesses entail complex risks, but also because of the changing nature of the risks pertaining to existing assets and businesses. The government could start by bringing together a commission consisting of private sector actors together with ‘Fossilfritt Sverige’, The Swedish Environmental Protection Agency, Finansinspektionen, the Ministries of Finance, Industry, Environment, and Infrastructure. We recommend that the government considers making a permanent organizational unit responsible for public-private risk balancing, for instance by creating a unit within a department, an agency, or even a ministry.

The government should develop its capacity to take direct action on sustainable finance which is as complementary as possible to that of the private sector’s initiatives. A central challenge of state intervention is that it entails a need to build capacity for governments to identify which sustainable investments to make. A mixed public/private investment approach could be adopted as a hybrid strategy to harness the best of both public and private sector investment practices. Alternatively, the government should seek to direct its public investments to the areas that are as complementary as possible to private initiatives in the field. Two such areas are: (1) the most innovative new products, services, projects or new technologies that show considerable potential but which the market perceives as too risky to fund, and (2) the most long-term investments, in e.g. infrastructure, which are vital to the climate transition but go beyond the investment horizon of many private market participants. Another important point here is to be mindful of the risk of creating a green financial bubble, as directly promotional policies could potentially increase the valuation of certain green (or merely greenwashed) assets beyond sound levels.

The Swedish government should launch an investigation into the feasibility of establishing a national green investment bank (GIB). This would be a publicly capitalized bank created to provide financial services targeting green projects and to facilitate private sector investments to support the transition to a low-carbon economy. The rationale for a GIB rests on the ideas that it: a) would be able to provide financial resources where other financial market actors are unable or unwilling to, b) that it could spur private sector investment via its banking activities, and c) that a Swedish GIB could efficiently coordinate with GIBs of other EU member states and other international GIBs. To ensure that a GIB functions as intended, the role and scope of the GIB, which lies somewhere between direct public funding support and private sector investment, needs to be clearly delineated. A GIB that crowds out private investment, or undermines or duplicates direct public funding efforts, would be counterproductive and costly. A GIB should operate with a strong and transparent sustainability objective and could thereby help reduce policy uncertainties with regards to the government's endorsement of directly promotional policies. A GIB could be capitalized by the state but also take in private capital, and thus potentially contribute to a good balance of risk-bearing between different financial actors. Experiences gathered from observing other EU countries' publicly backed investment banks provide valuable insights on how Sweden could consider approaching the issue of setting up its own.

Finally, **the Swedish government should investigate the possibility of channelling the money raised from sovereign green bonds into a separate budget for climate-related public investments, which is distinct from the broader state budget so that such investments do not have to compete against other public costs.** It is likely that many investment funds with a sustainability profile will buy the newly issued sovereign green bonds as a counterweight to their riskier investments in corporate shares. However, a relevant criticism of these bonds is that they were not intended to facilitate additional expenses in the state budget. That is, the relevant climate investments and railway maintenance costs were already included in the budget, and therefore the government failed to utilize the financial market's interest in sustainability to facilitate additional climate-related activities.