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Aligning capital markets with Europe's transition needs

Recommendations to use capital markets for supporting corporate and economic transitions on sustainability

- The EU has committed to better integrating capital markets, in order to promote investments for the bloc's strategic goals, including the shift away from risky and towards cleaner, more resilient activities.
- However, the plans lack specifics on how more efficient capital markets alone would enhance the economy's transition readiness. Without relevant incentives and disincentives, investments would not only be ineffective but could also ultimately work against the EU's well-being.
- It is crucial to put in place policies that empower banks, investors and other capital market actors to support the transition, alongside safeguards designed to prevent the financing of counterproductive activities.

Scaling up strategic investments—a prerequisite for EU's prosperity and resilience

The EU is facing a multifaceted crisis that threatens the prosperity of its people and businesses. The Russian war in Ukraine, an ongoing energy crisis, a shortage of skilled labour, growing social inequalities, a fragmented and inefficient Single Market, and an inconsistent regulatory framework are some of the complex challenges facing the EU.

Simultaneously, various sectors and regions within the EU are grappling with intensifying water scarcity, shifting weather patterns, more frequent fires and floods, and other changes in the physical environment. These pressures are leading to lower agricultural yields, disrupted supply chains, elevated credit risks, higher insurance and financing costs, and other challenges that threaten livelihoods, undermine companies' ability to generate value, and increase macroeconomic instability.

To ensure the resilience and prosperity of European households, firms and governments amid an increasingly volatile risk landscape, **it is essential to scale up more effective and strategic investments across the economy.** This involves not only reallocating existing financial resources to better meet the needs of the EU, but also mobilising additional capital.

EU’s current political direction on capital markets lacks strategy and purpose

EU leaders’ commitments to integrate capital markets pave the way for reforms that enhance such financing and support the green transition. The European Commission has pledged to better integrate capital markets in coming years in order to efficiently and strategically allocate more resources across the EU, including for the green transition. This comes after the improvement of capital markets was called for by the EU heads of states, ministers on internal market and industry, and eurozone finance ministers, as well as Letta’s report on the Single Market and Draghi’s work on competitiveness.

However, these statements lack detail on how more integrated capital markets would benefit and not hinder firms’ transition readiness and the economy. For instance, it remains unclear how expanding capital markets would stimulate non-financial firms to transition and help them prioritise long-term resilience and value creation. The responsible Commissioner is tasked, over the next five years, to "scale up sustainable finance, in particular transition finance and climate resilience", but concrete commitments cover only a small part of what has to be done in EU policies to enable effective financing for the transition. Without aligning capital markets’ aims with its people’s needs, the EU risks impairing its long-term success and stability.

It is imperative to put in place policies that (i) promote financing strategic directions that future-proof the EU economy and (ii) minimise the risk of counterproductive investments. This is especially critical for more risk-exposed sectors where capital markets should provide stronger incentives for coping with environmental challenges and navigating the transition.

Policies and safeguards for capital markets to help corporate transitions on sustainability

For banks, investors and other capital market actors to effectively support the shift away from riskier and harmful activities and towards cleaner ones, the EU policy framework must be made more clear, coherent and effective. This includes the need to:

- **Establish a clear definition of what constitutes a credible transition** for different economic activities and sectors, along with a **relevant transparency framework**. Currently, there is no strong framework outlining what makes a robust transition for assets, activities, sectors or financial products. This complicates efforts for companies and financial actors.

- **Develop a more effective system for incentives and disincentives** to encourage meaningful transitions to risk-resilient business models, and ensure investments would not work against the EU’s strategic directions, prosperity and resilience. Current incentives are often ineffective or counterproductive. For instance, the prevalent short-term incentives in many ways harm the longer-term transition needs. Additionally, due to the burden of proof, firms genuinely committed to transitioning face higher administrative costs compared to their less responsible counterparts.

- **Improve, standardise and align policies for efficiency and effectiveness.** Laws sometimes overlap, have mismatched definitions, lack synergies or do not work as intended. Laws could also be designed smarter. For example, the corporate sustainability reporting framework lacks standardisation, e.g. questioning the materiality of sustainability matters that are relevant for all sectors. Private finance should also align with the re-orientation of EU and national budgets and funds away from harmful and towards more responsible spending.

- **Strengthen accountability, oversight and supervisory measures to ensure transition efforts are integrated into general corporate strategies**. This includes providing clear legal expectations, guidelines and incentives to corporate leadership.

In light of this, **below are nine recommendations crucial for aligning the objectives of the European capital markets with the need to enhance the bloc's prosperity, resilience and transition capabilities** and ensure that the financial resources in the EU would accelerate not undermine progress.

Recommendations for capital markets to support more strategic transition finance

I. DEFINE WHAT IS TRANSITION

While the EU has made strides in defining what is sustainable, there is a critical need for clarity for companies, financial institutions and markets on what constitutes a credible transition and transition pathways at the company, activity, sectoral and financial product levels.

1. Company level: Establish a single corporate transition plan framework—linking over ten EU laws with different transition-related requirements—to support companies in setting targets and adopting and implementing a transition plan relevant to their contexts, for example, in the areas of climate, water, and various ecosystem services.

2. Economic activity and sectoral levels: Define transitional economic activities to clarify not only what is sustainable but also what it means to become resilient and sustainable in various sectors, as well as which activities can never be sustainable (e.g. via the EU Taxonomy, Corporate Sustainability Reporting Directive, and EU Green Bond frameworks).

3. Financial product level: Develop a framework for defining financial products and services focused on transition. This should include a mandatory product categorisation system with a transition category under the Sustainable Finance Disclosure Regulation.

II. DISCLOSING TRANSITION-RELATED MATTERS

Transparency on transition-related matters is essential for companies and financial institutions to be able to benchmark, and to enable the integration of transition elements in the capital markets.

4. Sector-specific reporting standards: Develop sectoral reporting standards under the Corporate Sustainability Reporting Directive by June 2026, ensuring these include information relevant to transitioning in different sectors and contexts, and provide the data that other financial legislation depends on.

III. INCENTIVISING FINANCING OF THE TRANSITION

Incentives for capital market actors are crucial for ensuring that investments support and reward transition efforts on corporate and financial sector portfolio levels. Without aligning incentives and disincentives in capital markets with the transition needs of companies and households, there is a high likelihood that the use of financial resources would be neither effective nor strategic.

5. Induce transition via engagement: Incentivise the financial sector to engage with companies that have higher exposure to transition-related risks, and promote the transition to more responsible business models and strategies. This can be pursued by establishing due diligence and relevant disclosure requirements for financial activities, and by strengthening shareholders' rights to promote more long-term corporate behaviour and transition strategies through engagement.

6. Account for transition-related financial risks: Integrate transition risks into risk-based capital requirements and credit ratings. This would increase the relative cost of financing more risk-exposed or non-transitional activities, and reduce the relative cost of financing activities and entities that have undertaken credible transition efforts, in line with the underlying financial risk.

7. Remuneration structures: Incorporate transition-related objectives into the remuneration structures of financial and non-financial companies, including by linking remuneration schemes to the objectives outlined in entity-level transition plans.

8. Incentivise retail investors: Improve the clarity and conditions for retail investors to invest in firms, funds and other instruments, which are more conducive to the transition. This includes better access to information, advice, incentives and opportunities via the EU Retail Investment Strategy, Sustainable Finance Disclosure Regulation, the Shareholder Rights Directive II, and other policies.

IV. ACCOUNTABILITY FOR AND OVERSIGHT OVER TRANSITION

For a meaningful transition to risk-resilient business models and strategies, the transition plan and efforts must be embedded in the overall business strategy. This requires providing corporate leadership with clear legal expectations, guidelines and incentives.

9. Duty of care and oversight: Ensure that transition-related activities and financing are subject to duty of care, oversight and accountability measures at appropriate levels within companies and financial institutions.