SUSTAINABLE FINANCING – EUROPEAN LEGISLATIVE FRAMEWORK AND IMPACT ON THE ECONOMY

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Abstract The financial sector is not immune to the risks caused by climate change and environmental degradation, and it follows trends and improves its contribution to sustainability. Strengthening economic and financial resilience to sustainability risks is one of the priorities of legislators at the global level. Sustainable financing as one possible solutions refers to the practice of providing funding to projects or businesses that promote sustainability, including social, environmental, and economic sustainability and the paper analyses its impact on economic development and increasing competitiveness. The aim of sustainable financing is to support projects that not only generate financial returns, but also have a positive impact on society and the environment. The paper is based on the analysis of empirical data and critical review of literature. Empirical data for the study are the secondary data retrieved from European Central Bank and European regulations.

Keywords:
sustainable financing, economic and financial resilience, circular economy, sustainable development, European Central Bank, European regulations

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1 Introduction

An effective and smooth transition towards a net-zero economy cannot be made without a coordinated response between fiscal authorities, central banks, regulators, and supervisors. Public policies created for the purpose of reducing climate change directly affect the economies of the member states, but also of the European Union and its single market. After the UN General Assembly adopted a new global sustainable development framework: the 2030 Agenda for Sustainable Development, which is fully compliant with the Sustainable Development Goals, the European Council confirmed the commitment of the Union and its Member States to the implementation of the 2030 Agenda in a full, coherent, comprehensive, integrated and effective manner (Regulation EU 2019/2088, 1).

The financial sector holds power in funding and bringing awareness to issues of sustainability, whether by allowing for research and development of alternative energy sources or supporting businesses that follow fair and sustainable labor practices (Bakken, 2021) and sustainable finance is one of key factors of the circular economy contributing positively to growth, development, and financial inclusion.

The circular economy is an economic system that aims to eliminate waste and promote the continuous use of resources. It is a model of economic development that emphasizes the importance of sustainability and seeks to replace the linear "take-make-dispose" approach with a more cyclical one. In a circular economy, resources are kept in use for as long as possible, waste is minimized and materials are regenerated at the end of their lifecycle. The circular economy has become increasingly important as a model of economic development that aligns with environmental and social goals. Governments and businesses around the world are adopting circular economy principles to reduce waste, conserve resources, and promote sustainable growth.

Sustainable financing refers to the process of raising and managing financial resources in a way that supports sustainable development, which is the ability to meet the needs of the present without compromising the ability of future generations to meet their own needs. This type of financing is designed to integrate environmental, social, and governance (ESG) considerations into financial decision-

making. Sustainable financing includes a range of financial instruments such as green bonds, sustainability-linked loans, and social impact bonds.

According to the Special Audit Report 22/2021 on the EU's approach to sustainable finance, "under the 2021-2027 Multiannual Financial Framework, the EU plans to support public and private investment by allocating at least 30 % of the EU budget to climate action. The EU budget part is estimated to be around €358 billion, including the €7.9 billion budgetary guarantee related to Invest EU. In addition, Member States will have to allocate at least 37 % of the funds they receive under the Recovery and Resilience Facility to supporting climate action. This is estimated to be around €268 billion."

Hence the question arises: how important an adequate legal framework is for the implementation of sustainable financing and how much it, as part of the circular economy, affects the increase in competitiveness?

The aim of this paper is to answer to that question, so authors discuss the very concept and types of sustainable financing as part of the circular economy, its legislative framework and find a link to the direct impact on the economy, as well as the potential increase in competitiveness as a result of sustainable financing of innovations and acceptance of the circular economy as condicio sine qua non.

The paper contributes to the literature by emphasizing the importance of adequate regulatory framework and its impact on boosting the global competitiveness in innovation and green and digital transition.

2 Theoretical Background

In the literature, definition and importance of sustainability, sustainable financing and its impact on the economy is analyzed from very similar perspectives. As previously said, the effective transition to a net-zero carbon economy requires a major shift in financial flows and it depends of coordination of financial policy bodies — financial regulators, ministries of finance and supervisors (Mikheeva & Ryan-Collinc, 2022; ECB, 2022).

Lovciová (2022) and Bednarčíková and Repiská (2021) define sustainability as protection of our natural environment and support of the balance between ecosystems and innovation. Abdalmuttaleb et al. (2022) explain that sustainability involves the adaptation of today's business model to the dynamic nature of the current digitalized environments and that corporations need to make sure that resources are being used responsibly and efficiently.

As previously said, sustainable financing includes a range of financial instruments such as green bonds, sustainability-linked loans, and social impact bonds.

Green bonds are debt instruments that are used to finance environmentally sustainable projects, such as renewable energy, energy efficiency, and sustainable agriculture. These bonds are certified by third-party organizations to ensure that the funds are used for sustainable projects. Like any other bond, a green bond is a fixed-income financial instrument for raising capital from investors through the debt capital market (OECD, 2015).

Sustainability-linked loans are a type of loan that incentivizes borrowers to achieve specific sustainability targets, such as reducing greenhouse gas emissions, by offering lower interest rates if the targets are met.

Social impact bonds are a type of financing that links financial returns to achieving social outcomes, such as reducing homelessness or improving education outcomes. These bonds are often issued by governments or non-profit organizations.

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Discussing about connection between sustainability and finance sector, Mikheeva and Ryan-Collinc (2022) emphasize the fact how historically, financial policy bodies have played a direct and coordinative role in industrial and economic development,

often via close collaboration with dedicated public financial institutions such as national development banks.

When analyzing the connection between sustainable financing and circular economy, it is easy to see their close connection as both focus on creating a long-term sustainable future. Sustainable financing is the practice of providing financial services to companies that operate in the most sustainable way possible, while circular economy is an economic system that aims to reduce waste and promote the use of resources in a more sustainable and efficient manner.

In a circular economy, products are designed to be reusable, repairable, and recyclable, reducing waste and extending their lifespan. Sustainable financing can help to support this approach by providing funding to companies that prioritize investments in circular economy practices, such as the adoption of renewable energy, the development of circular supply chains, and the implementation of innovative recycling and waste management processes.

Additionally, sustainable financing can also incentivize companies to engage in sustainable business practices, such as reducing their carbon emissions and using sustainable materials. These efforts can contribute to the circular economy by reducing resource consumption and waste production.

Overall, sustainable financing and circular economy are inherently linked as they both strive towards creating a sustainable future where economic growth is achieved without harming the environment or depleting natural resources.

This paper focuses on the importance of adequate legislative framework and the impact that sustainable financing has on the economy.

When analyzing the regulatory framework, the most important part of European regulation for sustainable financing are Regulation (EU) 2020/852 (the 'Taxonomy Regulation'), Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector and Regulation (EU) 2019/2089 as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks.

The Taxonomy Regulation is an important piece of legislation for enabling and scaling up sustainable investment and thus implementing the European Green Deal, including an economy that works for people and ensures a just transition that creates employment and leaves nobody behind. It applies to financial market participants that offer financial products, financial and non-financial undertakings within the scope of Directive 2014/95/EU (the Non-Financial Reporting Directive - 'NFRD').

"On November 28, 2022 the EU Council and European Parliament reached an agreement to adopt the Corporate Sustainability Reporting Directive (CSRD). The legislation significantly expands mandatory sustainability disclosure requirements for all large EU companies operating in the EU. More recently, the EU Council proposed to exempt banks and investment funds from CSRD following resistance from several member states including Spain, France, Italy and Slovakia. The draft proposal allows each member state to decide whether financial services providers should account for their environmental and social footprint" (ESG Book, 2022).

3 Methodology

The paper is based on the analysis of empirical data and critical review of literature. Empirical data for the study is the secondary data retrieved from European Central Bank, OECD and European regulations.

The paper analyzes the literature that has studied the relationship between energy-saving innovation and two broad factors: market forces and public policies. Studies using various methods and samples have reached the same conclusion: higher energy prices speed up innovation in energy-saving technologies and have major impact on sustainable (Breckenfelder et al., 2023).

According to Breckenfelder et al. (2023) the studies show that the energy efficiency of home appliances was strongly correlated with energy prices. Also, some studies find that a 10% increase in energy prices leads to 3.5% more patents in energy-saving technologies. If using aggregate data on GDP, energy, capital, and labor to compute a measure of the energy efficiency, studies show that energy efficiency has increased steadily since the oil shocks of the 1970s. If comparing how gas prices shape innovation in the car industry, there are conclusion that 10% increase in fuel prices leads to 8.5% more innovation that develops alternatives to fossil fuel engines, and

an 8.3% decline in innovation within the class of fossil fuel engines. In other words, the literature has broadly concluded that the direction of energy-saving innovation is endogenous and can be changed by market forces and adequate regulatory framework (Breckenfelder et al., 2023; OECD 2015).

4 Discussion and Conclusion

Sustainability is based on three pillars: economic, social, and environmental sustainability. Economic sustainability refers to the ability of an economy to support long-term growth and development. It includes creating jobs, reducing poverty, and promoting economic stability. Social sustainability refers to the ability of a society to support the well-being of its members and includes social equity, access to education and healthcare, and human rights. Environmental sustainability refers to the ability of natural systems to support life and maintain their ecological balance and includes protecting biodiversity, reducing pollution and waste, and addressing climate change.

Sustainable financing refers to the practice of investing in projects and businesses that promote long-term economic, social, and environmental sustainability. This type of financing can have a positive impact on the economy in several ways.

First of them is improved resource efficiency. Sustainable financing can encourage businesses to adopt more resource-efficient practices, reducing waste and lowering operating costs. This can lead to increased productivity and profitability, which can help stimulate economic growth.

Second one is increased investment in green technology. Sustainable financing can help direct investment towards companies that develop and produce green technologies, such as renewable energy, energy-efficient buildings, and sustainable transportation. This can create new jobs and industries, as well as reduce dependence on fossil fuels.

Third is related to reduced risk. Investing in sustainable projects and companies can reduce risk in the long term. For example, by investing in companies that have strong environmental and social practices, investors can avoid potential negative impacts such as environmental disasters or social unrest, which can have significant economic costs.

Improved reputation is also a way sustainable financing affects economy. Companies that prioritize sustainability and responsible practices may have a better reputation among customers, investors, and other stakeholders. This can lead to increased brand value and customer loyalty, as well as improved access to financing and investment.

Also, sustainable financing can spur innovation by incentivizing companies to develop sustainable products and services that meet the demands of environmentally conscious consumers.

Improving corporate reputation is another element of effecting economy by sustainable financing models. Sustainable financing can enhance a company's reputation by demonstrating its commitment to sustainability, which can help attract socially responsible investors and customers.

In big way sustainable financing can lead to reducing costs. Sustainable financing can help reduce costs by promoting energy efficiency and waste reduction, which can lead to lower operating expenses and higher profits.

Also, sustainable financing can help companies mitigate risks associated with environmental and social issues, such as climate change and human rights violations. This can help prevent costly legal and reputational damages.

And last but not least, sustainable financing is connected with supporting economic growth. Sustainable financing can support economic growth by promoting sustainable development and reducing environmental degradation, which can help ensure the availability of natural resources and preserve ecosystems.

Sustainable financing can help promote long-term economic growth and stability by encouraging businesses to adopt sustainable practices, invest in green technology, and reduce risk.

The impact of different sustainable financing models on organizations varies depending on their nature, size, industry, and financing needs. Here are some potential impacts:

Equity financing: Organizations that opt for equity financing sell a portion of their ownership to investors in exchange for funds. This model may be more suitable for startups or smaller businesses that have limited financial resources or no credit history. Equity financing could provide access to significant capital, but it also means that the organization has to share its profits with the investors and may have to sacrifice some control over its decision-making.

Debt financing: Organizations that choose debt financing take loans from financial institutions, such as banks or credit unions, and pay them back with interest. This model may be more suitable for larger organizations with proven track records and stable cash flows. Debt financing could provide a predictable source of funds, but it also means that the organization has to pay interest and principal on time and may face penalties for default.

Crowdfunding: Organizations that use crowdfunding platforms, such as Kickstarter, Indiegogo, or GoFundMe, ask the public to contribute small amounts of money to fund their projects or ventures. This model may be more suitable for organizations that have a loyal customer base or a compelling social or environmental mission. Crowdfunding could provide a way to test the market and engage with supporters, but it also means that the organization has to meet its fundraising goals and deliver on its promises.

Impact investing: Organizations that receive impact investments from investors who prioritize social or environmental outcomes along with financial returns. This model may be more suitable for organizations that have a clear social or environmental mission and can demonstrate their impact. Impact investing could provide access to patient capital and strategic partnerships, but it also means that the organization has to measure and report its impact and align its goals with the investors' values.

In conclusion, each sustainable financing model has its advantages and disadvantages, and organizations should carefully consider their goals, priorities, and capacities before choosing the most appropriate one for their needs.

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