Executive summary

Human activities are putting the environment under unsustainable pressure, through climate change and by degrading the earth's natural systems.

Up to a third of economic activity depends directly on ecosystem services provided by nature. Yet human activities are degrading the land, the oceans, and the atmosphere that sustain these services and the health of our natural capital continues to deteriorate.

Three types of project can help to halt this deterioration: **conservation** projects, for example designating areas as national parks and nature reserves; **restoration** projects, such as depolluting, renaturalising soils, or rewilding; and **transition** projects to adopt sustainable processes, such as switching to renewable energy or less intensive agriculture.

All these project types lack funding and as a consequence Europe is failing to meet its environmental targets. In this report we ask what type of finance could best fill the funding gap and which regulatory changes could mobilise private finance and unlock public finance for nature.

Recognizing the Limits of Private Finance

The funding gap for environmental projects in Europe, conservatively estimated at €400bn, has been hard to fill, despite abundant private liquidity. The nature of private investment is to focus on financial risks and returns and revenue streams, but **many nature-related projects have no revenue source**. Indeed, nature tends to benefit when there is less economic activity. Conversely, it can be easier to finance businesses that keep their costs low by harming nature. Attempts to create revenue sources from nature projects using innovative financing models have produced mixed results: ecotourism remains a niche; biodiversity offsetting has major conceptual flaws and a poor record of protecting nature; and Payments for Economic Services (PES) schemes such as conserving biodiversity or maintaining watersheds are, in reality, public subsidies.

What has worked well is where **existing businesses use funding to switch to sustainable processes** and create financial value through price premiums, adding to land values, or reducing the use of natural resources. Regulation can accelerate these effects. In agriculture, there are special problems such as balancing sustainability with crop yields or delivering finance for sustainability improvements to the world's 450 million smallholders.

Nature projects are often too small for institutional investors to invest in directly. They are complex to understand, illiquid and take a long time to mature. Global capital markets provide an indirect way for investors to invest with instant pricing and liquidity. However, the industry's reliance on CAPM and other structural factors mean that fund managers have little appetite for alternative or long-term investments.

Consumer demand for sustainable or ESG investing is on the rise and EU regulations now require funds to say how they integrate sustainability factors. By some estimates, sustainable investing represents around €22 trillion of assets under management in Europe, but the numbers and the impact depend on which sustainable investing approach is taken. Nearly half of these assets are subject to 'negative screening' which does not screen for nature loss and cannot directly change harmful behaviour. Other sustainable investing approaches may have greater impact.

Regulation could help to harmonise the different methodologies for assessing ESG factors, especially for biodiversity where techniques are less developed. But difficulties remain with obtaining and comparing underlying data on companies' environmental impacts.

Overall, preferences among capital market participants for liquidity, a market price and benchmark-hugging mean that few mainstream funds have the freedom to invest in nature projects. It seems that **sustainable investing is not yet ready to tackle biodiversity and nature loss,** or at least to have an impact on a significant scale.

Doing More Within the Limits of Private Finance

The EU has responded to the private financing gap for nature with two initiatives. The first is **the Sustainable Finance agenda, which aims to create a chain of ESG information** to help private investors invest sustainably. This chain includes a taxonomy to define what is sustainable, updated rules on non-financial reporting that govern how companies report on the sustainability of their activities, and a set of labels and standards to say which financial products support sustainable activities. The focus is on improving information flows, not on making projects more bankable.

The second is **the European Green Deal Investment Plan, which among other things provides a framework for blended finance,** where public money is used to make projects more attractive for private finance. The approach has been used in development finance, in funding the SDGs, and in the EU's 'EFSI' and 'InvestEU' programmes. It works by taking risks onto the public balance sheet through guarantees, grants and liquidity measures and is intended for projects that would not otherwise go ahead. Its main limitations are that it needs a revenue stream, which rules out a lot of nature-projects, and it can increase the reporting burden. Blended finance is already available for EU biodiversity and nature projects from the Natural Capital Financial Facility (NCFF) but has had a limited take-up.

Another way to protect nature is through **economic instruments that send price signals** and so shift profitability towards more sustainable activities. These include instruments to 'marketize' ecosystem services, such as creating claims linked to carbon sequestration, and cap-and-trade systems, which set an upper limit and then let the market decide who can pollute, fish, harvest etc. The failure of the EU's Emissions Trading System shows the importance of configuring these correctly and resisting the use of offset markets, which create new allowances that dilute the cap. There has been relatively little EU use of fiscal levers, such as Denmark's pesticide tax, or fiscal transfers for activities that benefit the environment, such as compensation for farmers who switch to organic methods.

Integrating Economic and Environmental Governance through the Green Deal

Given the scale of the problem, both private and public solutions are needed. **Public finance is especially useful for projects that provide public value without being financially bankable themselves**. The public value that nature brings is already targeted by the EU's comprehensive body of direct environmental regulations. These seek to ban harmful activities, limit pollution, protect land etc. but have not been fully implemented. The opportunity cost of not implementing them, in terms of foregone environmental and other benefits, is estimated at up to EUR 80bn a year.

Public sector investment has the freedom and scale to address nature-loss and create positive externalities, such as ecosystem services, in ways that private finance cannot. But in Europe, public investment is constrained by the fiscal framework among other factors and has been declining as a proportion of GDP for decades.

Despite efforts to exempt public investment from the fiscal framework, there is no consensus yet for a proposed **“green golden rule” to exempt green public investment**. The rapid suspension of fiscal rules during the COVID-19 crisis showed, at least, a recognition that accounting rules are not an objective in themselves and can be treated with flexibility.

The EU’s use of “Rio Markers” to **track its public investment in biodiversity** overstates the amount invested. More accurate numbers could be obtained with tracking based on the BIOFIN approach or by developing new markers based on the EU green taxonomy.

The EU itself has dedicated very little public funding for nature projects, only EUR 5bn under the LIFE programme and various other pots that protect biodiversity as a secondary objective. On the other hand, it continues to provide very large subsidies for harmful farming processes under the Common Agricultural Policy, as well as subsidies for fossil fuels and harmful fishing and forestry activities.

With limited firepower at the EU level, public investments in nature will have to be increased at national level. The EU Semester oversees national public investment for member states and there is **momentum for aligning the EU Semester process with environmental goals**. Several tools exist for this, including embedding the SDGs and environmental metrics in the EU Semester process; using information on countries’ implementation of environmental laws as inputs for EU Semester country reports; and including countries’ biodiversity policies as inputs to EU semester country reports, alongside their energy and climate plans.

Conclusion

Finding the money to tackle the emergency of nature-loss will need a fresh mindset that looks beyond the markets-only approach of yesterday and combines public and private financing. Nature-loss is a far bigger threat to human wellbeing than COVID-19 and the response to this global pandemic shows what can be done when there is a will to tackle a crisis.

Well-directed private finance can help businesses to become more nature-friendly and there is much that regulators can do to encourage this. But policymakers should not expect too much; **private finance is at best a partial solution**. It is viable only when there is a source of revenue and many, if not most, nature projects do not provide one, even when the value they bring to the economy and the environment is enormous.

Public finance will be needed at a scale that calls for national as well as EU budgets to invest directly and alongside private capital. The EU has tools to make this happen and the investment will be far less than the cost of responding to the COVID-19 crisis, indeed it could and should be part of the EU’s post-Corona recovery plan, perhaps framed as a **“Recovery and Transition Plan”.**

We look forward to the EU adopting a strong target-led nature strategy that will maximise the private sector’s contribution without relying too much on it, and unlock national and EU public funding at a scale that can reverse the damage that our economy has been inflicting unsustainably on nature.

Recommendations

The **EU 2030 biodiversity strategy** expected in Q2 2020 will set out the EU's objectives for nature. In Finance Watch's view, it is essential that this strategy promote ambitious targets and seek to integrate biodiversity into the EU's economic governance. We hope it will inspire changes in agriculture and trade policy and lead to a more complete and better enforced body of EU environmental regulation. The Commission's **EU Sustainable Finance agenda** is already well advanced and should now be completed with a taxonomy of unsustainable activities, robust rules on ecolabels and green standards, and measures to align environmental and prudential goals, among other things.

This report looks at ways to increase the funding available to protect and restore the EU's natural environment. It considers how the EU can maximise the private sector's contribution to nature investment, without relying too much on it, and unlock national and EU public funding at the scale needed. Finance Watch highlights four actions that we believe could help with these goals:

A. UNLOCKING PUBLIC FINANCE

The amounts of blended finance and direct public financing available at national and EU level could be increased by setting targets, easing certain constraints on public spending, and tracking public spending on nature and biodiversity more effectively. In order to promote an increase in financing for biodiversity and nature from all sources; to ensure that EU funding (including under the Common Agricultural Policy) does not undermine biodiversity goals; to lay the groundwork for a **"Green Golden Rule"** to reduce fiscal constraints on public investment in biodiversity and natural capital (for example by exempting Member States' spending under the Natura 2000 programme or restoration activities from the EU's fiscal framework); and to update the system of 'Rio Markers' so as to better track the impact of public budgets on biodiversity and nature; **we recommend that EU institutions:**

1 **Fully integrate and prioritise environmental objectives, including biodiversity, in the EU Semester** (see page 70)

2 **Review the EU's system for tracking the impact of public budgets on nature and biodiversity** (see page 67)

B. MOBILISING PRIVATE FINANCE

Sustainable investors can influence corporate behaviour more easily if **businesses' interactions with nature and biodiversity** can be measured. In order to support the EU's efforts to mobilise standardised approaches to compare business sustainability; to help businesses assess and reduce their negative impacts on biodiversity; to mobilize and increase private investments for biodiversity; to help make all private and public financial flows consistent with the post-2020 Global Biodiversity Framework; to prepare for future legislation on the measurement and disclosure of nature-based metrics; to embed double materiality (inside-out non-financial impact and outside-in financial risk) in the process; and to complement EFRAG's mandate to develop non-financial reporting standards; **we recommend that the Commission:**

3

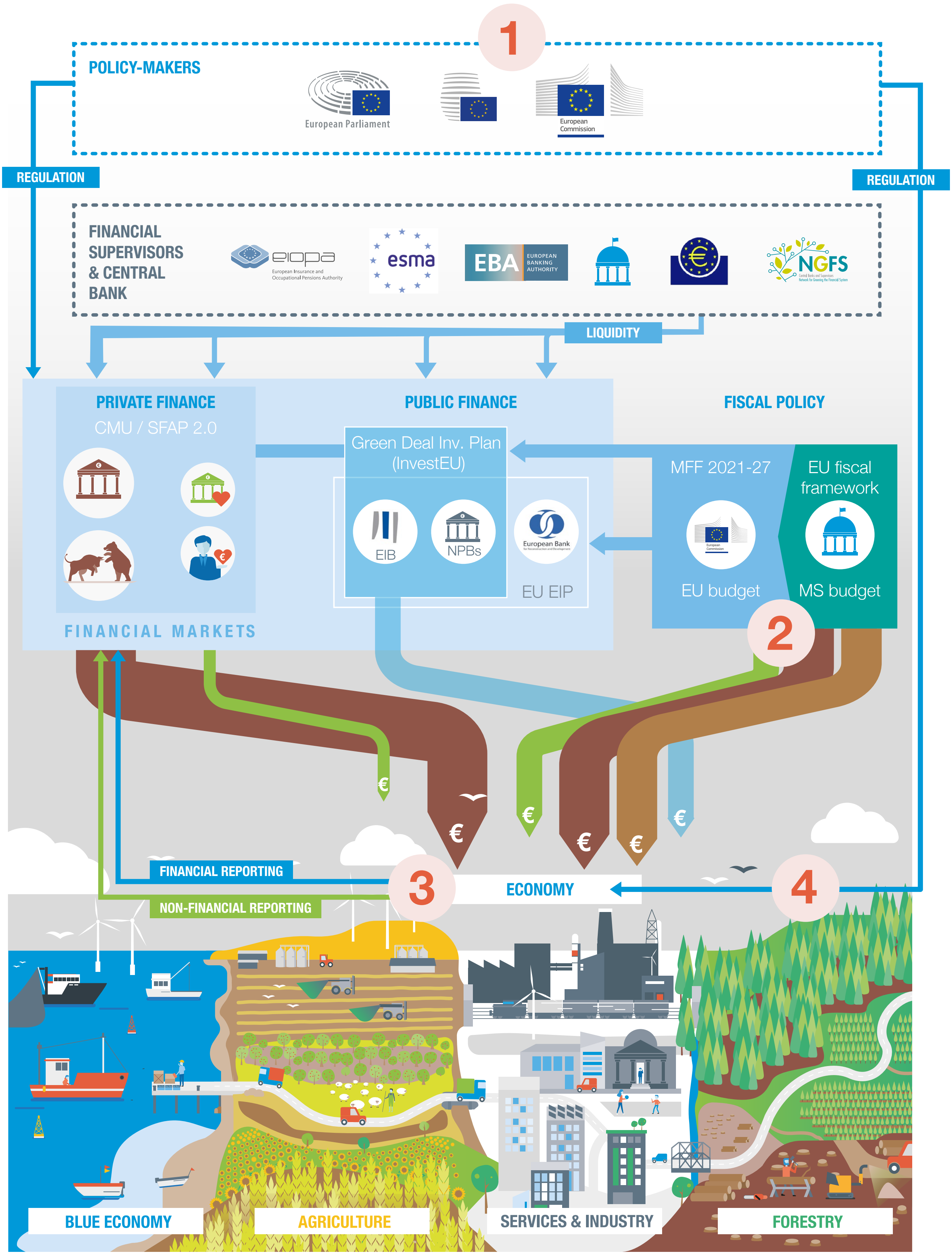
Mandate the Sustainable Finance Platform to develop a harmonised system of metrics and methodologies to assess the impacts, risks, and dependencies of economic and financial activities on biodiversity and nature (see page 42)

Economic instruments can help sustainable businesses to attract private finance by shifting profitability to sustainable activities, but they have had mixed results (such as biodiversity offsets, cap-and-trade, and other instruments). In order to ensure that only the most effective economic instruments are used; that they are calibrated to nature's limits; that they are not deployed in the place of more effective measures; and are not captured or diverted from their purpose; **we recommend that policymakers:**

4

Assess the effectiveness and suitability of existing and new economic instruments against their environmental objectives (see page 56)

Mapping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NGFS
LIQUIDITY
PRIVATE FINANCE
CMU / SFAP 2.0
PUBLIC FINANCE
FISCAL POLICY
Green Deal Inv. Plan (InvestEU)
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FORESTRY