Fostering investment in sustainable projects

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Climate change – no business as usual for risk management

With a pledge to provide USD 100 billion for climate action projects in the five-year period to 2020 and with some EUR 24 billion in green bonds issued over the past decade, EIB has strongly positioned itself as a leader in climate finance. To support transition to a "Paris-aligned" economy by providing financing is one side of the coin. There is, however, another side of the same coin, which is of particular relevance from a risk point of view: The requirement to assess the financial risks of climate change and of the business models and assets to which the green economy will give rise.

"Best banking practices call for a treatment of climate risk as a financial risk."

\- ALAIN GODARD

It is crucial to understand that best banking practices call for a treatment of climate risk as a financial risk rather than merely as a reputational issue. Measuring that, however, triggers a number of key questions:

Does the banking community have an accepted means of quantifying the climate risk in its portfolios? At present, with a few exceptions, the quantification of climate change risk still poses a challenge to banks and, crucially, no "market standard approach" for assessing such risk seems yet to have emerged. For example, significant work has been done on addressing transition risks – i.e. the risks inherent in financing assets or business models that may become non-viable (or "stranded") in the future. For EIB, however, given the Bank's heavy focus on infrastructure, it was also important to analyse physical risk right from the start – i.e. the risks to physical assets brought about by more uncertain future weather patterns. EIB's first climate risk assessment tool therefore follows a project-level approach, to be complemented with top down overall assessments, possible deep dives into the most exposed sectors as well as bottom-up analyses of individual counterparts. In developing this internal approach, the absence of well codified existing "risk tools" that are common in established fields of risk management (internal rating models, capital models, stress testing, etc.) is apparent and raises important questions around how the industry will collectively assess and report these risks in future.

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>>> **Is the banking community properly equipped to assess new and emerging business models?** Financial institutions can help enable companies' transition to a circular economy by providing appropriate financing, network development services, and advice. For linear banks (heavily exposed to "take, make, dispose" business model investments), credit risk assessment might not properly take into account the value of a circular product and its positive externalities, while linear risks like raw material price volatility and scarcity or stranded assets associated to their investment portfolio may be insufficiently acknowledged. A new mind-set in risk assessment practices, and potentially new tools, may be required.

Is the banking community fully aware of potential new risks embedded in "Paris-aligned" portfolios? As multilateral development banks are facing increasing pressure to be "Paris-aligned", and supervisors are working on taxonomies of green and brown assets, which may in due course attract differentiated capital treatments, we also need to ask the question to what extent a "Paris-aligned" portfolio is risk-proof. While being "Paris-aligned" may protect us against some transition risks, new risks can arise out of a strong exposure to green tech, for which proper assessment and monitoring is crucial. This includes supply/commodity risks and specific environmental risks related to rare earth and rare metals as well as specific cyber risks linked to digitalisation/artificial intelligence features embedded in green techs.

These are just three questions that climate risk and the new economy pose for bankers. They point to a necessary journey that will inevitably start with imperfect assessment tools, to be debated among banking practitioners. ●

Ana María Martínez-Pina García

Vice-Chair, Spanish Securities and Exchange Commission (CNMV)

Optimal role of the financial sector in the transition to a sustainable economy

This topic has become a standing item on the agenda of all international and national members of the financial sector after the lessons learnt from the recent financial crisis: the importance of climate and social matters, including gender and diversity balance, corporate governance and the need to focus on sustainable and long-term strategies.

Many international initiatives, such as the Paris Agreement or the UN 2030 Agenda, have mirrored these learnings and also show consensus on two issues:

- sustainability is crucial to ensure long-term competitiveness in the economy;
- the financial sector has a key role to play.

We can observe increasing attention to sustainability matters in the private and public sectors. In Europe, the private sector took the lead, to meet an increasing demand for financial products that take into account the social or environmental aspects of the investment itself. We have attended to the creation of collective investment schemes of different types (mainly funds) that are known as "ESG" and "collaborative" as they meet certain requirements that allow them to be labelled as such by different private associations.

In the area of domestic, public and saving banks, the sustainability trend has materialised in the issuance, among others, of the so-called "green bonds, "social bonds, "affordable housing bonds" or "water bonds". Some States and Central Banks have even issued their own green bonds.

"Every financial sector member has a role to play to promote the transition to a sustainable economy."

\- ANA MARÍA MARTÍNEZ-PINA GARCÍA

This responds to an increasing concern of society, and particularly of its youngest members, to invest in companies and assets that respect the environment, social rights and good governance practices. In this regard, the European >>>

>>> regulators set a milestone with the Non-Financial Reporting Directive[1] as it required certain companies to report non-financial information in their annual accounts. Thereafter, the European Commission Action Plan set out a roadmap with key items for the financial sector to consider. The European Supervisory Authorities (ESAs) have been actively working on the mandates received in relation to the Plan, as well as the rest of the financial sector, to try to smoothly prepare for the transition.

Securities regulators also have a role to play. The vast majority of us have the mandate to monitor the non-financial information disclosed by corporations and we must foster investor protection by providing the conditions that allow investors to have access to accurate and substantial information on ESG investments and risks.

Government initiatives aimed at promoting sustainability are also crucial. It is necessary to raise awareness, establish tax incentives and, in general, adopt measures that contribute to long-term investments and remove obstacles to innovative means of financing.

Every financial sector member has a role to play to promote the transition to a sustainable economy. The implementation of the European Commission Action Plan will benefit the competitiveness of EU companies and provide a level playing field for all market players. At the same time, a stronger coordination of supervisory activities across the EU will help us to make the Economic and Monetary Union more resilient. The private sector should continue to meet clients' demands and the public authorities should try to keep pace with these new trends, taking into account their legal missions, mandates and competences. ●

1. Directive 2014/95/EU of the European Parliament and of the Council, of 22 October, amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups.

Laurent Zylberberg

Director of Public, International and European Affairs, Caisse des Dépôts (CDC) & Chair, European Association of Long-Term Investors (ELTI)

NPBIs, a decisive support for the Invest EU programme

The National Promotional Banks and Institutions (NPBIs) are committed in boosting long-term investment throughout the European Union (EU). In less than two years the next Multi-annual financial framework (MFF) will give NPBIs the opportunity to make EU financing more impactful and more visible locally.

In this framework, the "InvestEU programme", successor of the Investment Plan for Europe (the so-called "Juncker Plan"), should contribute to resolve the intricate equation of doing more and better with less.

This instrument will be key in maximising the impact of the European budget by offering a rationalized structure and grouping a multitude of EU financial instruments currently available under a single umbrella, thus offering greater flexibility and efficiency. The InvestEU programme is a key step for embarking all actors.

It will also rely on multiple implementing partners including national actors, like Caisse des Dépôts Group (CDC), such as NPBIs. Opening direct access to the EU guarantee will bring more complementarity which are crucial in financing smaller and riskier projects by relying on three know-how methods:

- "labelling" to identify on-the-ground projects with the most added value (both economically and socially);
- "bundling" of small projects together (to collect them into 'packages' allow to meet the critical financial threshold) and;
- "blending" those projects which require both subsidies and financing. In any case NPBIs will help to crowd-in private financing resources.

The National Promotional Banks and Institutions share a common goal: fostering the economic development of their country by relying on their financial and technical expertise with targeted financing solutions for both key innovative infrastructure and economic stakeholders targeted for the development of underserved territories and actors.

"The next MFF will give NPBIs the opportunity to make EU financing more impactful."

\- LAURENT ZYLBERBERG

They also share a common voice at EU level, through their European association of Long-Term Investors association (ELTI) and have over the past years demonstrated their ability to cooperate with European Institutions. Individually and through their common association ELTI, NPBIs are ready to provide their support, common experience and financial capacities for the full success of those indispensable new instruments.

The National Promotional Banks and Institutions are ready to get involved in this market-based and policy-focused instrument to achieve sustainable, inclusive and innovative goals and to helping mobilise €650 billion in additional investment by 2027 and therefore greatly enhancing the outreach of the EU support. ●

Suzanne Buchta

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Bank of America Merrill Lynch

The financial sector needs to accurately gauge transition risks

The financial sector will play a crucial role in the transition towards a global low-carbon economy. However, the sector currently faces a challenge of how to value accurately the risks of such a transition. One place to start could be by questioning implicit assumptions in current 'financial risk analysis', and by considering other risks that have either been overlooked or ignored. These assumptions and risks include:

1. That resources are infinite instead of limited and constrained;
2. That current technologies are stable and efficient instead of easily disrupted;
3. That client demand is entrenched in current technologies rather than shifting.

For finite resources such as water, precious metals and other rare minerals, the financial sector may need to start assuming a charge for them, similar to the congestion taxes levied by a number of inner cities or the emissions taxes charged by airlines. Taking into account the current population growth trajectory multiplied by the growth in resource use per person, the financial sector will need to reconsider the associated risks in its lending/investment portfolios in order to appropriately value the constrained resources.

In addition to changes in the level of constraint on natural resources, technological disruption can create risks where previously there were none. Consider, for example, the massive technology improvements in renewable energy over the last 10 years. Now, in a number of sunny regions, new solar installations price at or below parity to new coal builds that generate the same energy output. What does this technological shift do to the inherent risk in a coal portfolio (perhaps at least part of the reason why we see so many coal exit announcements)?

Finally, are consumer preferences changing? We have already seen the plight of high street retailers caused by consumer shifts to online purchasing, and it is not difficult to imagine a similar situation affecting energy-acute sectors such as transport. If electric vehicles become as cheap to produce and buy as diesel vehicles, might consumers not eschew the latter for the former? If so, what does that demand shift do to the value of a portfolio of loans to car manufacturers who have no electric vehicle model/factory/supply chain?

The financial sector needs to reflect on its risk analysis to take into account more fully this change in assumptions. The path towards transition will have to include more accurately capturing, analysing and valuing risks in the lending and investing portfolios of financial institutions. This will pave the way for a sounder and more climate-conscious allocation of capital, which will in turn help address future environmental challenges. ●

Ingrid Holmes

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What is the necessary role of the financial sector to accelerate the transition?

In 2014, the New Climate Economy report confirmed that the transition to a low carbon economy is feasible and that the requisite capital to fund it is available. However, it also notes that delivering this transition in way at that minimises shocks to the financial system – i.e. through what central bankers refer to as an 'orderly transition' in the timescales required - will require investors, corporates, governments and individuals working consciously and collaboratively to achieve this shared goal.

Within the financial sector awareness of the grave risks but also significant opportunities posed by the climate challenge is growing, driven by initiatives such as the Paris Agreement on Climate Change and the Taskforce on Climate-Related Financial Disclosures and the efforts of many governments to start to decarbonise their economies. In some countries, renewables outweigh fossil fuels in the power generation mix. In others, electric cars are already more cost effective than petrol and diesel alternatives. Elsewhere, corporates are adopting regenerative agriculture techniques that protect and enhance the environment, improve carbon storage and cut the dependence of farmers on agrochemicals, many of which are derived from fossil fuels.

But despite these good news stories, much more remains to be done. New EU investors disclosure rules aim to accelerate the mainstreaming the consideration of these issues into investors existing due diligence and risk management processes and will help with awareness raising. The expectation is that through this means climate change and

wider ESG factors will start to be factored into company valuations and access to and the cost of capital for firms. In time we should also expect to see new climate aligned benchmarks becoming more widely used by asset owners to award mandates.

Changes to MiFID2 and the Insurance Distribution Directive will help identify latent demand for more sustainable approaches to investing, which currently make up around 20% >>>

>>> of EU assets under management, by requiring sellers of investment and insurance products to consult clients on their sustainability preferences.

Understanding political and regulatory risk as drivers of value will also be key to banks and investors – but equally so is understanding that constructive dialogue with government is important to create the market frameworks under which the new low carbon economy will be created.

But it is not only investment decision making and valuation processes that must adapt. Given how far away we still are from delivering a low carbon world, arguably the biggest change asset owners, investment managers and indeed capital market makers such as the investment banks can make is to engage with companies most exposed to the low carbon transition. These engagements should look to address climate risks or opportunities and challenge companies to move further, and at a faster pace, through assertive stewardship. This is something the newly updated EU Shareholder Rights Directive encourages.

The financial sector is in unique position to help accelerate the transition to a low-carbon economy through being mindful of the way that it allocates its resources and engages with investee companies on the need for change. In doing so we can achieve lasting economic growth while also tackling the risks of climate change by seizing the opportunities presented by those providing capital solutions. ●

Sirpa Pietikäinen

MEP, Committee on Economic and Monetary Affairs, European Parliament

Transition to sustainable economy necessitates changing our financing model

The transition to circular, sustainable economy requires considerable adaptation by public authorities, businesses and households. It will necessitate transformation of business models but also financing models.

Globally, the investment gap to finance a transition to a low-carbon, resilient economy is US$90 trillion by 2030. This is approximately how much will be invested in infrastructure by 2030, and about the size of assets under management globally. The equation is clear. If we are to be serious about tackling climate change, sustainability needs to be part of every financing and investment decision taken today.

Public spending should be in line with these objectives. Every year US$5 trillion, a staggering 6.5% of the global GDP, is distributed to fossil fuel subsidies. It is evident that these trillions could be put in better use.

Similar scrutiny should apply to all EU funds, financing instruments and programmes, as well as the financing operations of the European Investment Bank and the European Central Bank. The InvestEU programme, a successor of the European Fund for Strategic Investments, can have an important role in financing sustainable infrastructure by mobilising private finance through EU budget guarantee and in facilitating a pipeline of investable projects together with national and regional partners. Over 30 percent of the €38 billion budget guarantee is earmarked for financing sustainable infrastructure. The Parliament has demanded raising the financing target to 40 percent.

Sustainability needs to be considered in all sectors, not just in project financing. The EU and its Member States will need a climate-proof budget that integrates sustainability indicators and assessment of environmental impact in budgetary planning and spending. The next EU Multiannual Financial Framework will need to see higher ambition on mainstreaming sustainability and climate objectives, raising it from the current 20 percent to 25 for 2021-2027, and to 30 by 2027 at the latest, as asked by the Parliament.

A climate proof budget entails critical scrutiny of distorting or uncompetitive subsidies through all sectors. Agricultural and cohesion funds alone make up over 70 % of the EU budget. These funds should be directed to finance circular and climate-proof technologies and innovation within these sectors. Similarly, public authorities themselves are large consumers. By considering environmental impact and life cycle of products and services, public purchases can have an important impact in boosting sustainable goods and services. Green Public Procurement and inclusion of innovation partnerships should become a rule.

A pipeline of sustainable projects is likely to accelerate in the future following the introduction of a future EU taxonomy that will help assess sustainability of an economic activity. A low-carbon and circular growth model is also an economic opportunity. Global Commission on the Economy and Climate has estimated that climate action could deliver over $26 trillion in economic benefits and generate more than 65 million new jobs by 2030.

"Finance is the key factor in the fight against climate change that either makes it or breaks it."

- SIRPA PIETIKÄINEN

Public spending can only be a tip of the iceberg in financing the transition to sustainability. Majority of global finance is private, and currently to a large extent invested in a way that supports unsustainable growth.

Our efforts should not only be about earmarking a tranche of finance to sustainable objectives or stopping investments to harmful activities. It should be about creating a double effect by changing the underlying market incentives themselves.

By gearing the private financial flows, we can create a true avalanche to a climate resilient, circular economy. Finance is the key factor in the fight against climate change that either makes it or breaks it. ●