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Economic Policy Positions

Sustainable finance: Helping to mitigate climate change on a long-term basis

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Summary

In view of the wide range of challenges facing society, the chief economists and sustainability experts of the Savings Banks Finance Group agree that it is of prime importance to focus on sustainable structures in society. One important area of the challenges is environmental and climate protection. Enterprises in all sectors of the economy should conduct their business in an environmentally friendly manner. However, since mere appeals are not effective enough and a number of mechanisms (negative external effects, giving priority to short-term benefits versus long-term sustainability) often stall sustainable business operations, the government is called upon to create an environment that fosters sustainable activities of enterprises and individuals. The government, in turn, should create these prerequisites in cooperation with other countries, as environmental issues are global issues.

As a matter of principle, government regulation should always follow market economy principles, i.e. steering effects should be achieved through prices because detailed rules on the way in which products can be produced in a given sector lead to sluggish and cumbersome processes. This also applies to the financial sector, which must first develop its own sustainable production methods. In these efforts, the sector can also be incentivised and supported by government regulation. The institutions of the Savings Banks Finance Group are prepared to address these challenges and to support sustainable finance. Investors also have great interest in sustainable products. The European Union rightly wants to use the investors' willingness to make their capital available for sustainable projects, so as to strengthen sustainable finance which can help, for instance, to control global warming. In this context, the chief economists and sustainability experts of the Savings Banks Finance Group consider the following points to be important:

- The sustainability criteria to be defined should be as comprehensive as possible and from the outset include not only climate issues but also questions of the social and economic responsibility for sustainable structures.
- A goal-oriented environmental policy should be focused on market-based instruments.
- Sustainable finance also means preserving stability in the financial system itself. In the European Union, supranational institutions need to agree with national authorities on a closely coordinated division of labour in establishing and enforcing a uniform sustainable regulatory framework.
- If "green" finance is to become more attractive for society, one way of achieving this should be to use incentives which, however, should not call into question the stability of such finance, let alone the stability of the financial system itself. On the other hand, government can strengthen the transparency of the sustainability characteristics of various types of finance and financial instruments, so as to increase awareness of the lower long-term risks associated with sustainable finance.

Sustainable finance: Helping to mitigate climate change on a long-term basis

With reference to one of the key points of the climate debate – the emission of greenhouse gases – it should be noted that the contribution which sustainable financing rules can make to solving the problem is far less important than that of another set of rules: The effectiveness and efficiency of emissions trading cannot be overstated with a view to achieving emission reduction targets, e.g. for carbon dioxide. This trade in emission rights is capable of identifying and making use of the best methods for avoiding the release of harmful substances in the overall economy. We support the concept of an internationally coordinated expansion of the trade in carbon emission allowances to include all relevant polluters.

In the past, issuing emission allowances has not yet led to the achievement of the environmental targets. It is therefore important to continue to use trade as a means of limiting carbon emission volumes, so as to ensure that the climate targets can be achieved. In addition, specific excise duties and income taxes can also provide incentivising effects for the achievement of environmental targets. Overall, we believe that an open debate is necessary – both in the real economy and in the financial sector – about future general carbon pricing either by expanding the European Union’s emissions trading scheme or by introducing a carbon tax that is socially acceptable and allows for different sector-specific transformation periods. Yellow-vest protests in France have shown that such approaches might prove to be critical, both in terms of environmental policy and from a socio-political perspective.

At European level, several projects aimed at strengthening sustainable finance are currently under discussion. During the new legislative period following the election of the European Parliament, it can be expected that the European Commission will continue to actively pursue these initiatives.

From an economic perspective, sustainable products need to develop in competition with each other. In this context, the players in the financial markets should develop an incentivising market standard in their own best interest in order to provide sustainable services in competition with each other. The legislator should therefore develop a sustainable regulatory framework. Investors should not be patronised in their investment decisions. The supply of sustainable financial products available in the market should be expanded; in any event, investors must given a choice.

With a volume of more than 430 billion US dollars in Q1/2019, the issuance of new sustainable finance instruments has reached a new record high. The volume had been significantly below 100 billion US dollars just 5 years ago. In addition, a recent IIF study of April 2019 has shown that the largest issuers are from China, France, and Germany. These three countries together account for over 40 percent of the activities in the markets for green bonds.

The Savings Banks Finance Group supports the United Nations’ 17 Sustainable Development Goals as the key yardstick for action. For this reason, we are closely monitoring the trend towards more demand for sustainable investment products – as well as sustainable lending – and the fact that many financial service providers have developed such products which they are now offering to investors. In this process, financial stability is a valuable asset. The stability of the financial system must not be compromised by the measures intended to promote its sustainability. The rules on regulatory capital requirements and on the equity ratio must also apply to sustainable finance. The rules need to be designed so as to prevent economic misallocations and the development of cluster risks.

Additional bureaucracy should be avoided. Any new requirements imposed on banks and Savings Banks, customers – in particular SMEs – and green investors should be minimised by reducing burdens elsewhere. The implementation and monitoring of sustainability criteria in companies, for instance, always need to be justified in relation to their tangible benefits. There is an urgent need for a Europe-wide strategy and a national strategy for sustainable finance. These strategies should be developed by the German government and, as of autumn, by the newly elected EU Parliament and the EU Commission, following consultations with the Finance Committee, the advisory councils on sustainable development and independent expert committees. One option might be to establish advisory councils on sustainable finance at national and European level to deal with sustainable finance on an interdepartmental basis.

An additional option that is up for discussion is to give preferential regulatory treatment to the acquisition of "green" bonds – as well as the provision of "green" loans – in order to make this asset class more attractive for investors. Such measures could help give "green" bonds a qualitative advantage over conventional bonds in future. There is an ongoing debate about assigning a lower risk weight to the acquisition of "green" bonds and to the provision of "green" loans ("green supporting factor"). An alternative introduced in the current debate by market observers is to assign a higher risk weight to the financing of industries that are particularly harmful to the environment ("brown penalising factor"). In our view, such an approach is only justified if this is corroborated by empirically confirmed risk characteristics of "green" or "brown" finance. The empirical studies currently being conducted are therefore important, and the introduction of such factors should be contingent on the evidence provided by these studies. Without such evidence, the core of the stability rules for the banking sector might be compromised, and the sustainability of the financial sector itself might be undermined by allegedly promoting sustainable finance.

Current market trends

The interest of investors in sustainable investments appears to be as strong as ever. As an example, we would like to draw attention to the call-to-action published by a total of 415 large investors (big banks, pension funds, life assurance companies, asset managers) prior to the United Nations climate change conference at the end of 2018 in Poland. In this statement, the investors called on governments around the world to step up their efforts to achieve the climate goals agreed at the World Climate Conference in Paris. Overall, these large investors represented 32 billion US dollars in assets under management.

The European Union would like to tap this enormous investment potential to ensure that the climate goals of the Paris Agreement will be achieved. At the World Climate Conference in Paris, the international community agreed in December 2015 to limit man-made global warming to significantly less than 2°C – if possible, to 1.5°C – compared with pre-industrial levels. At the United Nations' Katowice Climate Change Conference in December 2018, the parties adopted a comprehensive rulebook for the practical implementation of the Paris Climate Agreement, which entered into force in November 2016. The core of the Agreement is formed by transparency rules and standards for monitoring carbon emissions, which will apply as of 2024 and are intended to make the global warming management efforts of countries comparable with each other.

The European Union has already taken steps to create a positive environment for sustainable investments in its sphere of influence. The most important contribution to date has been the publication in March 2018 of the EU Commission's action plan on sustainable finance. In this paper, the EU Commission presents a total of ten measures to achieve its objectives:

- Reorienting capital flows towards a more sustainable economy
    1. Building up a detailed EU classification system for sustainable activities (taxonomy)
    2. Introducing standards and labels for "green" financial products
    3. Fostering investment in sustainable projects
    4. Including sustainability considerations in financial advice
    5. Developing sustainability benchmarks

- Mainstreaming sustainability into risk management
    6. Better integration of sustainability into market research and credit ratings
    7. Clarifying the sustainability duties of institutional investors and asset managers
    8. Consider incorporating sustainability into prudential requirements

- Fostering transparency and long-termism
    9. Strengthening the rules on the disclosure of sustainability information and on accounting
    10. Fostering sustainable corporate governance and counteracting capital market short-termism

The EU will implement some of the objectives through legislation (Regulation), primarily points 1, 4, 5, and 7. More than anything else, a unified, easily comprehensible and practical taxonomy for the financial markets would mean a quantum leap because this would considerably simplify the analytical effort to be made by investors.

The measure which in our view is the most important planned innovation – a unified definition and classification system for ecologically sustainable economic activities (taxonomy) – was already adopted at the plenary session of the European Parliament. However, the EU Member States have not yet agreed a common position. The Taxonomy Regulation can therefore not be expected to be adopted before the end of 2019 at the earliest. It is necessary to have a lean and flexible taxonomy which can also be applied by small and medium-sized enterprises without a great deal of bureaucracy, but which – at the same time – is unambiguous enough to effectively prevent "greenwashing".

Furthermore, the European Commission has instructed the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA) to develop proposals for integrating sustainability factors and risks into capital-market-oriented legislation. The European Banking Authority (EBA) has also been given the assignment to examine how to deal with the ESG risks in the SREP and whether targeted regulatory treatment of risk positions in connection with ecological and/or social objectives appears to be justified.

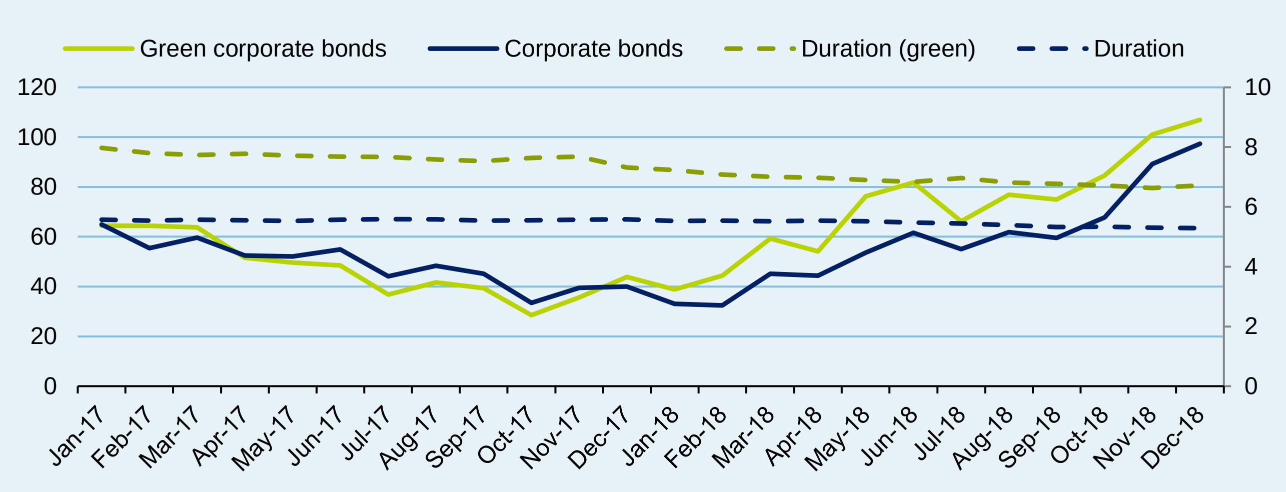
In our view, such reviews should be performed subject to the strict proviso that the general risk-based approach of banking regulation will not be compromised. Market players had until 19 February 2019 to comment on the proposals in consultation procedures. The supervisory authorities published their proposals ("Final Report") on 3 May 2019. The EU Commission still needs to accept the proposals and adopt the updated delegated legal acts. It is hard to predict the timetable for the further implementation. It is problematic if proposals such as the Disclosure Regulation or the Delegated Regulation on MiFID II are dealt with as a priority in order to rapidly implement the sustainable finance agenda, although key questions have not been clarified. It is imperative that, after the elections to the European Parliament, the various legislative proposals on sustainable finance be dealt with in sync or closely connected with each other; in particular, the taxonomy should be closely involved in the future planning as a basis for developing a common understanding of sustainable finance.

Green supporting factor and brown penalising factor: Foundations are currently inadequate

In our view, it is important to consider incorporating sustainability into prudential requirements. In this context, one idea that has been put forward is to assign a lower risk weight to sustainable investments than to conventional investments. This "green supporting factor", as it is referred to, is considered to be so important because it presents a good opportunity to give "green" bonds a quantitative advantage over conventional bonds. Another idea that is being discussed as an alternative is to introduce what is referred to as the "brown penalising factor", i.e. higher capital requirements for financing investments from industries that are particularly harmful to the environment.

The yields on "green" bonds and conventional bonds of the same risk category do not differ significantly. While there are differences between the "green" and the conventional yield curve for some issuers, these are purely technical in nature. The slightly higher demand for "green" bonds, which is driven by specialised investors, is not sufficient to create a measurable difference in yields. Since sustainable investment strategies entail a greater analytical effort, the bottom-line return on sustainable investments is often even lower than the return on conventional investments.

Chart: Spreads of green bonds develop no better than spreads of conventional bonds



ASW spread in bps (lS) and average portfolio duration (rS)

Source: Markit, BayernLB Research

If encouraging the acquisition of green bonds or the provision of green loans is to be used as a political instrument to stimulate the necessary enormous investments in sustainable projects, these additional costs need to be at least compensated, if not overcompensated. The necessary investor demand and, hence, the associated growth, will probably only increase significantly if the sustainable asset class has a measurable yield advantage to offer. Suitable measures designed to prevent a greater analytic effort and higher costs associated with sustainable investment strategies include the development of a generally accepted taxonomy in conjunction with transparency requirements which oblige companies and project sponsors to disclose audited parameters that are needed to assess sustainability. In addition, (sustainability) rating agencies can make these assessments more cost-effective as a result of experience and economies of scale.

However, the prudential treatment must not ignore the actual risks associated with bonds. The very purpose of prudential requirements is to avoid cluster risks. In this context, it should be remembered that the last financial crisis, which was focused on the U.S. real estate sector, had disastrous effects. Today, bonds once again play a very important role in the financial sector and should therefore be primarily assessed in terms of their risk.

Generally speaking, it is also doubtful from a regulatory perspective whether prudential requirements should be used to trigger socio-political developments. In the final analysis, it is people with their demand for sustainable products and financial investments who can accelerate sustainable development. When it comes to investment products, people should be able to freely decide on the basis of transparent information what mix of risk, liquidity and yield suits them best. For institutional investors with relevant disclosure requirements, strengthening their reputation or avoiding reputational damage can be an additional benefit in money's worth of green investments. In this respect, it is still completely unclear how the transformation of society will unfold.

In addition, empirical studies that assess the impact based on a taxonomy are not yet available. Several stakeholders such as the European Mortgage Federation are trying to change this and are carrying out the necessary studies. The European Union itself is also conducting additional studies and has asked the most important market players for their assessment. As long as there is no robust empirical basis for a special regulatory treatment of green or brown bonds, preferential regulatory treatment should take second place to the use of tax incentives to encourage the financing of sustainable projects.

Priority for financial market stability

However, regardless of the different approaches, one thing remains clear: If climate risks are given special regulatory treatment, it needs to be ensured that the stability of the financial sector will not be jeopardised. To this end, any quantitative change in the current capital adequacy rules should be substantiated by empirical studies and models. In the case of green investments, this poses a particular challenge because, due to the novelty of climate risks, it is not possible or very difficult to include them in historical studies and models. For this reason, regulators should think about various risk scenarios and how they would affect the credit risk.

Rating agencies – both traditional ones and, more recently, sustainability agencies – should play a leading role in assessing the risks. Due to their risk assessment expertise and their unique access to companies and their information, they could ensure that risks will be adequately assessed. This could be achieved either by involving the rating agencies in defining sustainable/green investments (taxonomy) or by separately publishing climate and environmental risks within the framework of the rating process.

Transformation calls for economic policy incentives

With reference to the climate and energy targets, an annual investment gap of approx. 180 billion euros has been identified for the European Union alone. To close this gap, the financial sector will make its contribution as a service provider for the real economy. However, the transition process to a low-emission and sustainable economy will have to take place in the real economy itself, i.e. in commerce and trade, as well as in the transport and construction sector. This will require an increase in fundable sustainable development projects and initiatives. For this purpose, government can create suitable incentives, which are briefly outlined below.

The question as to how the external costs of carbon emissions can be internalised is very important from an economic perspective. As already mentioned, it makes sense to have an open debate – both in the real economy and in the financial sector – about future general carbon pricing either by expanding the European Union’s emissions trading scheme or by introducing a carbon tax that takes into account social sustainability, public acceptance and sector-specific transformation periods.

In our view, other options of governments include new funding approaches for sustainable infrastructure and other investment projects. Furthermore, government might adopt measures designed to improve the credit quality of issuers by accepting default risks. The transformation process will require innovation, as well as new processes and products. For this purpose, companies will need to make substantial investments in research and development, which could benefit from preferential tax treatment because they foster sustainable development. In addition, both enterprises and private individuals will need advance investments in modern public infrastructure to be able to avoid or adapt to climate change. This applies in particular to municipalities and rural areas that need, for instance, efficient network connections nationwide.

Overall, the real economy will play the key role in the transformation process. Government can support the transformation with its economic policy. In cooperation with the other players, the financial sector will be able to make its contribution to facilitate this process. Sustainable finance is an important building block, but certainly not a panacea for paving the way for the transition to a low-emission and sustainable economy to mitigate climate change.

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