POSITION PAPER

ESBG response to the Questionnaire by the High Level Expert Group on sustainable finance interim report

ESBG (European Savings and Retail Banking Group)

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Q1: From your constituency's point of view, what is the most important issue that needs to be addressed to move towards sustainable finance? (sustainable finance being understood as improving the contribution of finance to long-term sustainable and inclusive growth, as well as strengthening financial stability by considering material environmental, social and governance factors)

Sustainable development requires sound economic policy underpinned by coherent financial regulation that allows for long-term investments by both governments and private investors. If recommendations n° 5: "A sustainability test in financial legislation", and n°7: "Position the European supervisory agencies on sustainability" are applied, they would be a powerful lever to promote sustainable finance.

We support very strongly the stance taken by the HLEG that the concept of sustainability needs a broad approach and includes not only environmental issues (like the fight against climate change) but all aspects fostering an inclusive economic and social development.

There is a long tradition in fostering inclusive growth throughout Europe via providing SME financing using customer deposits. In order to achieve sustainability, it is important to remove barriers to long-term financing. ESBG is of the opinion that sustainability requires a significant increase e.g.in green infrastructure investments. The strict ECB monetary policy and low interest rates makes it more complicated for banks to accelerate their long-term lending capability to SMEs.

SMEs are still turning to banks for business loans more than other sources of financing (such as bonds or equity issues). This is due to lower transaction costs, lower disclosure obligations, and the possibility to acquire small amounts of money. Thus, it might be useful to re-strengthen the idea of relationship banking versus transaction-based approaches to guarantee more stable financial conditions.

A certain level of flexibility and proportionality will be needed to ensure the clarified fiduciary duty can be applied across the investment and lending chain and its many different financial instruments, building on the existing principles in relevant EU legal texts. This should ensure that material ESG factors are integrated into the national definitions of fiduciary duties.

A holistic approach towards modernising the regulatory and legal framework in order to promote finance which is supporting the UN SDGs is necessary. ESBG highly appreciates the EU's commitment to meet global endeavours to promote sustainable finance (for example the UN Sustainable Development Goals and the recent G20 Leaders' Declaration of Hamburg) and the EU-level work (such as the EU response to the 2030 Agenda for Sustainable Development (10370/17), or the recent proposal of the European Economic and Social Committee to introduce a "Supporting Factor for Social Enterprises" (2017/C 209/36)).

One of the main challenges is a coherent definition of "green/sustainable assets". This should not only include "green bonds" but all kinds of assets which contribute to a society which is accepting "climate change" as a threat to our future and will do everything possible to reach the 2°C target (COP21). This society should also pay attention to its use of natural resources in order to not limit future generations from also using such natural resources (recommendation n° 1).

As the Report highlights that sustainable finance is a more comprehensive concept incorporating environmental, social and governance (ESG) factors, it would be interesting to carefully explore the idea of a supporting factor - taking these ESG goals into consideration - which is applicable to capital requirements for exposure to sustainably categorised assets.

In that sense, we welcome any capital benefit/relief (based on risk-related evidence) that would foster the growth of sustainable assets. However, it must be ensured that this would not trigger heavy and resource intensive reporting or disclosure requirements. We have learned that a second phase of analysing the current capital requirements for green assets is in the pipeline, which could lead to more specific recommendations. We suggest involving the financial industry in this process when developing concrete proposals for changing the current Basel rules. The quarterly reporting requirements could also be misleading, as sustainable projects require long-term financing which might not show immediate positive results.

Finally, the environmental risks need to be adequately assessed so that they can be taken into account in the CRR review, as climate change and environmental changes are classified as systemic risk.

Q2: What do you think such an EU taxonomy for sustainable assets and financial products should include?

It is difficult to clearly label sustainability. Maybe it's better to define assets and financial products according to their impact on the environment and society, as well as agreeing what is an acceptable impact. On the one hand, sustainable assets need to become a mainstream product and a key part of economic activity. Therefore, all investments and innovations that improve productivity and dematerialise economic activity (e.g. saving resources, promoting a circular economy, 3D printing, reducing greenhouse gas (GHG) emissions) are sustainable investments. On the other hand, at the moment it is important to promote specific projects related to the COP21 goal of 2ºC, and, on a wider scale, the seventeen SDGs. Long-term infrastructure investment should become a key component of economic policy and should be done in a way that crowds in private capital. To do so, financial regulation must be aligned with, and not hamper, sustainable development.

It is vital that a wide range of banking products are included in an EU taxonomy, such as green certificates of deposits which are often launched by local banks and Sparkassen in Germany. In addition, this class should not be more stringent than other classes, and focus on long-term results instead of short-term goals.

Q3: What considerations should the EU keep in mind when establishing a European standard and label for green bonds and other sustainable assets? How can the EU ensure high quality standards and labels that avoid misuse/green-washing?

Transparency and reporting are two of the key considerations to be kept in mind. If the EU wants to endorse sustainable activities in the financial sector, it would be better to create a label for outstanding financial companies in sustainability, in different categories (e.g. retail banking, insurance, investment banking), rather than a financial instrument. Moreover, there is already a banking group that labels green bonds (Green Bonds Principles). EU standards should align with international ones, such as the Climate Bonds Initiative.

In addition, including experts from all types of financial institutions into high-level groups would allow for a broader pool of experience when coming up with new ideas.

Q4: What key services do you think an entity like "Sustainable Infrastructure Europe" should provide, more specifically in terms of advisory services and connecting public authorities with private investors?

An entity like Sustainable Infrastructure Europe might be of high value. It should be connected to other existing entities such as the European Investment Bank (EIB) and cooperate with national or regional promotional banks like KfW in Germany and Finpiemonte in Italy, in order to ensure national requirements are also respected.

A major shortcoming is the lack of public financing of infrastructure. There can be no doubt that investment into an adequate and performing infrastructure is of key importance to the achievement of sustainable development. A useful definition of sustainable infrastructure has been put forward by a recent report of the New Climate Economy Commission: "Sustainable infrastructure includes all major energy, transport, telecoms, water and waste investments. It also covers the infrastructure required for effective land-use management. Infrastructure that meets key economic, social (inclusive) and environmental (low-carbon, resilient) criteria is deemed to be sustainable".

Finally, exchanging experiences and best practices among Member States could be a beneficial activity carried out by Sustainable Infrastructure Europe.

Q5: It is frequently stated that the inherent short-termism in finance, especially financial markets, represents a distraction from, or even obstacle to, a long-term orientation in economic decision-making, including investments that are essential for sustainability. Do you agree with this statement?

Yes.

Q5.1: If you agree with this statement, which sectors of the economy and financial system are particularly affected by the 'mismatch of time horizons'? What are possible measures to resolve or attenuate this conflict?

Banks and institutional investors are better placed than insurance and pension funds as they have more experience with long-term goals. These sectors could be helped by an adequate accounting process.

Q6: What key levers do you think the EU could use to best align the investment and analyst community with long-term sustainability considerations in the real economy?

The main levers to align investors and analysts with long-term sustainability are regulations such as establishing a relevant price on externalities not included in current prices. For example, a price on carbon which is high enough to promote the transition to renewable energies or to develop carbon-capture technologies. In general a realistic CO2 -related pricing on any kind of product would be the best tool to allocate investments and to influence consumption. To create preferably market-based systems reflecting the correct pricing for the externalised costs of CO2-emissions is the challenge.

Another action which would help move towards long-term sustainability is to change the practice of quarterly reporting into annual requirements. However, as long as the general economic system is based more on short-term incentives than on long-term targets this will be a challenge.

Finally, the EU decision makers should recognise the crucial role that banks play in intermediating between lenders and borrowers, in particular the percentage of savings banks' activities which cover SME and private households lending. Promoting these activities further will be beneficial to the real economy.

Q7: How can the EU best create a strong and visible pipeline of sustainable investment projects ready for investment at scale?

In the proposal for a new "European Consensus on Development" the European Commission proposes a blueprint for aligning the EU's development policy with the UN 2030 Agenda for Sustainable Development. The objective is to do more, do it better and do it differently. In ESBG's opinion, the most important objective is 'do it better', measuring the effectiveness of development actions and focusing on results.

For example, the European Fund for Strategic Investment (EFSI), managed by the EIB, has capital of €21 billion. The money is used for viable but risky projects, in order to help raise private capital up to the €315 billion capacity. Although this is a good initiative, it falls short of the public investment needed to put the European economy on the sustainable track. This could be resolved by leveraging private investments with EU public funds.

A key factor in investing in sustainable projects is that they are economically viable. Banks, other lenders and investors want their money back with profit. Thus, the greatest challenge might be to create projects in the real economy with an acceptable risk-return-profile for the financial industry.

As a vast number of green investments will be needed at local level, it is vital that local authorities, SMEs, private customers and local banks work together in developing ideas for sustainable projects.

Q8: What are some of the most effective ways to encourage credit rating agencies to take into consideration ESG factors and/or long-term risk factors?

A. Create a European credit rating agency designed to track long-term sustainability risks
B. Require all credit rating agencies to disclose whether and how they consider TCFD-related information in their credit ratings
C. Require all credit rating agencies to include ESG factors as part of their rating
D. All of the above
E. Other

Q8.1: Please specify what other ways you would deem most effective in encouraging credit rating agencies to take into consideration ESG and/or long-term risk factors.

Q9: What would be the best way to involve banks more strongly on sustainability, particularly through long-term lending and project finance?

ESBG is of the opinion that there are three main barriers for banks to actively promote sustainable finance:

1. **Regulation**. Bank activities are highly regulated, so if you want them to be active in this field, regulation has to be aligned with the goal. However, the Basel Committee has not been addressing systemic environmental risks, nor has it been encouraging national regulators to ask bank risk officers whether they are measuring the bank's exposure to environmentally-unsustainable activities. Removing the administrative burden of smaller, less-risky banks would allow them to concentrate on new market conditions rather than on administrative burdens. ESBG agrees that the regime of regulation and support should be straightforward, clear and stable over time, e.g. for green taxes or feed-in tariffs.

2. **Risk**. A bank's behaviour is very sensitive to risk perception. For the moment, a lot of sustainable projects are perceived as risky, (e.g. electric cars, some modalities of renewables, the lack of commonly agreed procedures and standards for energy efficiency, investment underwriting, and increased transaction costs). The principle of proportionality should be applied which includes less requirements for low-risk business, with local authorities, SMEs and private customers and/or for low amounts of lending and investment. Whether a green adjustment of minimum capital requirements is applicable has to be investigated very carefully. An important point here would be a broad and realistic definition of "green assets", and to recognise the broad definition of sustainable finance, meaning the development of a financial system that also tackles long-term education, economic and social issues

3. **Recognition**. Savings and retail banks are crucial in providing SME financing. ESBG members have an SME lending volume (stock at the end of 2016) which equals €500 billion representing 35% of the EU market share and around 15% of ESBG's lending portfolio. SMEs are key as the main providers of jobs. In 2015, SMEs accounted for 99.8% of all enterprises in the non-financial EU business sector, employing almost 90 million people – 67% of total employment – and generated 58% of the sector's added value. SMEs largely prefer bank loans for funding (75% of outstanding SME funding in Europe comes from banks), and evidence shows that bank lending remains the favourite source of SME financing for 50% of SMEs.

However, indirect regulation of the real economy by making it mandatory for lenders to take sustainability requirements into consideration, particularly in the area of corporate funding, must not be allowed to inhibit the ability to innovate.

There are still ongoing discussions in the CRR review regarding the introduction of a green supporting factor, similar to the SME supporting factor. The outcome of that discussion should be taken into account by the high-level expert group.

Q10: What would be the best way to involve insurers more strongly on sustainability, particularly through long-term investment?

Savings and retail banks should be able to finance sustainable projects and investments and be allowed to securitize (at least) parts of these assets to sell to insurers as a long-term investment. If Member States guarantee instead of finance such sustainable infrastructure projects, then it would be a better alternative to long-term sovereign bonds.

Q11: What do you think should be the priority when mobilising private capital for social dimensions of sustainable development?

As pointed out before, key for investments in sustainable projects is that these projects must be also economically viable. Banks and other lenders as well as private investors want their money back, otherwise they are not investors but donors. Thus, the greatest challenge might be to create projects in the real economy with an acceptable risk-return-profile for the financial industry and for private investors.

Private capital will only be used to invest in long-term sustainable projects if, in addition to an acceptable return on investment, these projects are secure and have a positive impact on our society.

Q12: Do you have any comments on the policy recommendations or policy areas mentioned in the Interim Report but not mentioned in this survey?

Climate change is one of the most topical themes. To internalise external costs, it would be very valuable to strengthen CO2-emission trading schemes to allow a CO2 price which reflects the social costs more correctly. A realistic CO2 pricing on any kind of product would be the best tool to allocate investments and to influence consumption. To create systems generating a realistic price mechanism for CO2 emissions is the challenge.

Furthermore, this would allow us to estimate operating costs of enterprises more in line with the Paris declaration. In some countries, such as Germany, a system is already in place which has proved its efficiency through national or regional promotional banks – such as KfW – which provide refinancing means in order for banks and Sparkassen to finance sustainable investment projects and therefore foster the transition towards a green economy. The already successful system which exists in some countries should be promoted first and enlarged as it was the case with KfW-ELENA.

As a general principle, regulatory intervention should be kept to the minimum. A better approach would be to encourage the market to develop a long-term sustainability mind-set through targeted incentives. We agree that greater engagement of the banks in long-term infrastructure financing requires a regulatory framework that remains stable over the long term.

Q13: In your view, is there any other area that the expert group should cover in their work?

Enhanced incentive systems could lead to further engagement with respect to sustainable finance. The chances of enhanced incentives should be further discussed.

As a final recommendation to the group, ESBG would encourage it not to lose track of the demand side which should steer the directions of sustainable product development.

About ESBG (European Savings and Retail Banking Group)

ESBG brings together nearly 1000 savings and retail banks in 20 European countries that believe in a common identity for European policies. ESBG members represent one of the largest European retail banking networks, comprising one-third of the retail banking market in Europe, with 190 million customers, more than 60,000 outlets, total assets of €7.1 trillion, non-bank deposits of €3.5 trillion, and non-bank loans of €3.7 trillion. ESBG members come together to agree on and promote common positions on relevant regulatory or supervisory matters.

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