POSITION PAPER

Moving towards sustainable finance: a perspective of local banks

ESBG (European Savings and Retail Banking Group)

Rue Marie-Thérèse, 11 - B-1000 Brussels

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1. What has made sustainable/green finance so essential now?

The Brundtland Commission, convened by the United Nations in 1983, produced the report "Our Common Future" which established the widely-accepted definition of sustainable development as "meeting the needs of the present without compromising the ability of future generations to meet their own needs[1]". The definition is supported by the equally widely acknowledged three pillars: economic, social and environmental development.

Sustainability has since become a generic concept used in a variety of domains in order to support the worldview that economic, social and environmental are fundamentally interlinked and must therefore be considered in unison[2]. According to the UNEP FI report, "ESG (environmental, social and governance) factors are considered as a subset of non-financial performance indicators, which serve to evaluate corporate behaviour and determine the future financial performance of companies."

The **social** criteria looks at a company's business relationships. A company's values should also be the values of its suppliers, and the company should look after its employers and stakeholders. The company should take into account aspects such as the diversity of its staff, human rights and consumer protection.

Corporate **governance** covers the rights and responsibilities of the management of a company – its board, shareholders and the various stakeholders in that company. Investors want to know that a company uses accurate and transparent accounting methods, see that common stockholders are allowed to vote on important issues, and would rather not invest in a company that engages in illegal behaviour or uses political contributions to obtain favourable treatment. In December 2015 the EBA's Guidelines on sound remuneration policies were published, to ensure that institutions calculate correctly and consistently the bonus cap by setting out specific criteria for mapping all remuneration components into either fixed or variable pay and detailing how specific remuneration elements such as allowances, sign-on bonuses, retention bonuses and severance pay are to be recognised over time.

In the **environmental** area, key drivers are the necessary change from a fossil fuel based energy production to energy from renewable sources to overcome the climate change and the more efficient use of all kinds of resources due to the rapid depletion of raw materials (circular economy) to become more sustainable. Together, in recent years these have brought about two important challenges:

- to take into account the new risks linked to climate change;
- to fight against global warming, by fully participating in the transition to a low-carbon economy which implies promoting the development of "green finance" and supporting "green economy", keeping in mind that sustainable finance goes much beyond low-carbon emissions.

Behind climate challenges lies economic competition in the energy sector. Since 2009, the game changer is the decrease in the profitability of oil production versus the increase in profitability of sustainable energy which will lead to a low-carbon – and therefore greener – economy. The increase in renewable energies, including at micro-level (such as households), and in energy efficiency has led to a massification of the market which attracts investors. Banks are seen as pivotal in this evolution.

It is important that the consumers understand the benefits of sustainable energy. Although the currently cheaper oil prices encourage consumers to buy oil/gas fuelled products, there are many long-term benefits of energy efficient products and it is important to instil consumer social responsibility.

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[1] Report of the World Commission on Environment and Development: Our Common Future, March 1987, page 41.
[2] UNEP FI Guide to Banking and Sustainability, October 2011, page 12.

Before 2009, decarbonisation was historically a world-wide issue of which Europe's savings banks were conscious. They were key actors and drivers of sustainable economy in areas such as healthcare, education and the economy as they were in contact with local communities where these services were necessary; they started the motors of sustainable development both in Europe and world-wide. The social progress on supporting local economy, health economy and education were supported. Green growth was done in some savings banks, not all, and is now increasing exponentially. Climate and poverty challenges cannot be solved without economic and financial progress.

2. What are international and European decision-makers currently up to?

a. International level

The Millennium Development Goals (MDGs) were the eight international development goals for the year 2015 that had been established following the Millennium Summit of the United Nations in 2000, and established measurable, universally-agreed objectives for tackling extreme poverty and hunger, preventing deadly diseases, and expanding primary education to all children, among other development priorities. One of the goals was to ensure environmental sustainability.

The Sustainable Development Goals (SDGs) followed the MDGs and were drawn up at the United Nations Conference on Sustainable Development in Rio de Janeiro in 2012. The UN objective was to produce a set of universal goals that meet the urgent environmental, political and economic challenges facing our world. The SDGs set out by the UN Development Programme (and adopted by the European Parliament) are shaping the global agenda in terms of how actors can contribute to sustainable development. In particular, the 17 goals involve significant changes to the way resources are used around the world, and two are particularly relevant:

- Investment in **infrastructure and innovation** are crucial drivers of economic growth and development. Technological progress is key to finding lasting solutions to both economic and environmental challenges, such as providing new jobs and promoting energy efficiency. Promoting sustainable industries, and investing in scientific research and innovation, are all important ways to facilitate sustainable development.
- **Climate change** has been caused by an increase in greenhouse gas emissions, and are now more than 50 percent higher than their 1990 level. Global warming is causing long-lasting changes to our climate system, which threatens irreversible consequences if we do not take action now. There is a need to limit the increase in global mean temperature to two degrees Celsius above pre-industrial levels. This requires urgent collective action.[3]

b. G20 level

The G20 has acknowledged the economic competition and made the green economy a top priority on its agenda. A green economy can help with both short- and long-term goals to minimise the factors which contribute to global warming. The international agreement in Paris at the meeting of the COP 21 in December 2015 has delivered the goal, the strategy and the agenda for the transition to a low-carbon economy which has a very strong financial component. On the table at the COP 22 in November 2016 was the method of applying the Paris Agreement, as well as debating the financial re-

[3] http://www.undp.org/content/undp/en/home/sustainable-development-goals.html

sponsibility for loss and damages, which was recognised under the Paris Agreement. In addition, transparency rules regarding the information provided by countries pertaining to the steps they take to reduce their greenhouse-gas emissions featured high in the discussions.

c. European level

The European Commission is also very active in this evolution. First attempts were made in the European Union through the Lisbon Strategy devised in 2000 by the European Council. Its aim was to make the European Union the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion, by 2010. The European approach published in November 2016 will make the UN SDGs a guiding principle as part of its better regulation package under the 2030 agenda. Sustainable finance recently came back in the limelight, following the impetus given at G20 level; Commission Vice-President Valdis Dombrovskis made the following declaration on 27 September 2016: *"We need to be bolder when it comes to supporting sustainable finance. This means looking for ways to encourage institutional investors to have more sustainable investment policies. But also, to see how we can support the transition to a low carbon economy in the financial sector. Work is underway to increase the availability of green funds through the European Fund for Strategic Investment."*[4]

Various Commission DGs (GROW, FISMA, CLIMA and ENER) are active on different aspects of sustainable development via their work on a green economy, de-carbonisation, energy efficiency and global warming, and established an Energy Efficiency Financial Institutions Group (EEFIG) in 2013.

On 31 October 2016 the European Commission launched a call for experts to setup a high-level group on sustainable finance. The decision builds on the Commission's goal to develop an overarching and comprehensive EU strategy on sustainable finance as part of the Capital Markets Union. The Joint Office will support the application of ESBG members, if necessary, who wish to apply for this group. The group will comprise 20 senior experts who represent a policy orientation common to different stakeholder organisations. The group's tasks shall be to help develop an overarching and comprehensive EU strategy on sustainable finance to integrate sustainability in EU financial policy.

3. Why do local banks have such an essential role to play?

Savings banks have an essential role to play to resolve climate change and reduce levels of unemployment, and the benefits have been felt throughout Europe. Recent studies show that it is the SMEs which create jobs in Europe. The biggest challenge to the European job market is not found in the markets, but in the regions. That is how Europe can find a positive, constructive response which will additionally help to combat Brexit.

Savings and retail banks are deeply rooted locally and benefit from the trust of their clients, holding a fiduciary responsibility. As a bank's role is to assess and analyse the risks in order to grant credits, its proximity to its clients, in particular households and SMEs, entail that local banks are best placed to accompany green development.

Local banks are able to finance "green economy", of course provided that their prudential constraints remain manageable. However it is imperative to foster the reliance of the green ecosystem (i.e. all the

[4] A High Level Expert Group is currently set up by the European Commission in order to help to shape the policy agenda; it should be operational in January 2017.

stakeholders involved) through for instance insurance products which guarantee the performance of the work undertaken.

Therefore, the dimension of local retail banking, which follows a decentralised model (and not a corporate model), should be more present in international work on this matter, carried out by the G20, OECD, or FSB, which focus too much on financial analysis and market tools. Therefore the following approach could be developed: a) take the bank financing (via the transformation of deposits) as the first and foremost source of financing; b) use the financial markets as a complement.

Locally-focused ESBG members are committed to promoting sustainable financing and urge G20 leaders to integrate retail and local banks within the international negotiation on aspects of financing, in particular due to their role in households and SME financing. In other words, local banks should be included in the international negotiations on sustainable finance; a dedicated task force or at least a specific session should be dedicated to them.

The responsibility for succeeding to reach the challenging international and European goals is shared: regulators and supervisors, municipalities, SMEs, households and of course banks.

- The savings and retail banking model creates growth and jobs as it finances SMEs, which are the engine of growth in the EU.

The focus, both at international and European levels, is currently on how to foster growth and jobs. It is vital for the European Union to relaunch growth of its firms in order to overcome the economic crisis.

SMEs are key as the main providers of jobs: in 2014, 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 also accounted for 71.4% of the increase in employment in 2014 in the non-financial business sector. SMEs largely prefer bank loans for funding (77% of outstanding SME funding in Europe comes from banks), and evidence shows that bank lending remains the favourite sources of SME financing for 50% of SMEs. However, only 10% of SMEs consider access to finance as their primary issue, despite regional variations. Finally, 78% of SMEs receive all or part of the loan requested while rejection rate has been continuously declining from 15% in 2009 to 8% in 2015. Savings and retail banks are crucial in providing SME financing: ESBG members have an SME lending volume (stock at the end of 2014) which equals €500 billion representing 35% of EU market share and around 15% of ESBG lending portfolio.

The role of SMEs in a sustainable EU environment should also be highlighted and has had more attention paid by the institutions in recent years (e.g. EC Green Action Plan for SMEs). In a context of rapid expansion of the green sector internationally, estimated at 5% per year, SMEs should be considered as a changing force with the capacity of transmitting innovative solutions to the EU economy. The opportunities offered by green growth can be of interest to a large number of SMEs, as an estimated 40-45% of them are companies with high environmental impact. Such impact sectors include manufacturing, energy production, transport and construction. Other studies at national levels demonstrate the significant role of SMEs in the green growth[5].

[5] 92% of green projects are carried on by SMEs according to a Banque Populaire study on green growth. Already in 2007, the most common type of green technology developing organisation interviewed for the report on Obstacles and Barriers to Funding Environmental Technologies and Clean Energy (FUNDETEC report) were SMEs (please see chart 4.2-3 of the report, page 13).

In this context, savings and retail banks are key actors in financing SMEs' green projects[6] and the cooperation of local banks/local public authorities/SMEs, via the issuance of loans stemming from local savings, appears critical to allow the green economy to grow sustainably and to provide jobs. Savings and retail banks play a key role in financing the improvements in energy efficiency, both in residential and commercial buildings, as well as in equipment used by SMEs. Some ESBG members are already in the process of offering sustainable-specific loans which combine returns with respect for the environment.

The European budget 2014-2020 also represents an opportunity for employment through local financing of SMEs via a wide range of financial instruments including equity facility, debt facility or loan guarantee facility. In this respect, the COSME and Horizon 2020 programmes should continue to support SMEs' innovative green projects taking into account that environment is a top priority for 39% of EU SMEs[7].

The sharing between markets and bank financing should be made based on competition and jobs considerations, which plead for deeply involving the SMEs in energy transitions as they are able to conciliate it with the creation of jobs. Thus the role of local banks should be promoted towards SMEs, in particular through the strengthening of refinancing and guarantee tools.

In the European implementation of the G20 activities on climate, low-carbon/green economy could be tackled through the angle of households and SMEs which create most of the EU growth and employment; for this purpose, local banks should be encouraged to contribute to the financing of households and SMEs. Several tools could be promoted such as: promotion of advice to households, reduction in risk weights linked to SME exposures (known as the SME supporting factor in the EU); development of bank refinancing in cooperation with regions; refinancing through investment or central banks which cover several jurisdictions.

- Savings and retail banks finance households, which are at the heart of the transition to sources of renewable energy.

Time has come when other ways of accumulating energy have developed: power plants are no longer the sole energy provider; households are henceforth able to produce their own energy and to become self-sufficient. The possibility for households to become autarkic or self-sustaining from an energy perspective is giving rise to a new paradigm where households could be more independent from the distribution networks (known as the "off-grid") and improve their purchasing power.

For this purpose, households need to be given access to financing which is precisely the role of local banks. This is why more and more local banks organised themselves in order to provide households with the required expertise in sustainable financing. Local banks aim to provide financial experts who are specialised in green finance for households and SMEs. In co-operation with energy professionals, they calculate the cost/benefit of their green projects, give advice on appropriate financing and tax

[6] For example, in Germany, savings and cooperative banks are the largest contributors of financing solutions for SMEs green projects with a total amount above €10 bn of projects financed in 2012. A similar trend can be observed in France where local banks are very active in the SME green market with a total amount of €4bn of SMEs green projects.
[7] Flash Eurobarometer on SMEs 02/12/2015

incentives and public subsidies – if there are any. Many illustrations of this system can be found for instance in Germany[8], France[9], Switzerland[10].

- Savings banks play a role in opening their network to everyone, and help to educate citizens in the region in which they operate

The European Stock Market Learning (ESML) initiative is an online competition run by European savings banks, giving students the opportunity to invest virtual capital on the stock market. Trading is based on share prices on real stock exchanges. The ESML provides an opportunity for young European citizens in business and financial affairs to learn about the stock market and gives them a chance to better understand the fundamentals and rationale of the economy and return and risk concepts. In addition, it is the opportunity to understand the wider issues which have a knock-on effect on stock markets, not only to speculate. Financial literacy levels in young European citizens is crucial, in order to allow them to make informed choices about their financial options in the future. As part of the ESML, there is a prize given to the group which carries out the most successful sustainable investment.

Financial inclusion and financial education are two further initiatives in which Europe's savings banks are heavily involved. Savings banks have financially-inclusive business models, and provide low-cost services to everyone. Local banks also work within their regions, talking at schools and local events in order to give information on the kinds of products available and the importance of saving money for the future.

- As a consequence, the role of local retail banking is essential and should not be neglected by the decision-makers.

In the financial area, focus has been put on an approach based on products, inspired by financial markets (in particular third-party investment as private/public partnerships did, private equity, stock exchange introduction, more recently bonds). These options presented in the Lisbon Strategy 2000-2020 are not sufficient and did not prove successful and did not fulfil the objectives. One reason is that local financing has been put aside and was not involved in this investment strategy. International activities target investment banking and project infrastructure; they unfortunately forget about the local banks.

A bottom-up approach which focuses more on the energy market, where households and SMEs are key players, would have advantages. This is why, due to the role described above, local banks have an indispensable role in financing the economy, and specifically green economy. Giving access to credit is the daily business of local banks - financial markets being a useful complement, for instance, in the case of large SMEs.

[8] For more details, please refer to the initiative "energieland 2050" accessible on http://www.energieland2050.de/
[9] Programme ELENA-KFW which was applied in 2012 to French regions.
[10] MINERGIE label largely used by Raiffeisen Bank, Coop Bank, la Banque Alternative de Suisse, and some "banques cantonales".

ANNEX: Other sustainability-oriented policy lines

1. **What else could local banks do?**

Local banks could be part of the **circular economy**. The Commission Action Plan for the Circular Economy to boost global competitiveness, foster sustainable economic growth and generate new jobs was published in December 2015 together with revised legislative proposals on waste. This package aims to rethink Europe's economic model, reduce waste and keep the value of products, materials and resources in the economy for as long as possible. In June 2016, the Council adopted conclusions on this action plan, committing to the planned transition towards a more sustainable model. The Commission is working to reinforce circular economy-related innovation at EU level and attract outside investors, and the financial sector will play a key role in moving Europe towards a circular future.

In March 2016 the Commission held a seminar on circular economy financing in order to gauge appetite among national promotional banks and other investors for platform to support the financing of the circular economy and to raise awareness about the challenges and opportunities related to the rapidly growing area of financing 'circular businesses'.

Savings banks will be impacted in their market by SMEs, as SMEs will invest in the eco-design of products and where recycling SMEs will have new sources of business. An influential battle between economic actors (large companies versus SMEs) is likely to occur on recycling products with high added value (see note in appendix). Local banks should push for prioritising economic support tools targeting SMEs (such as development aid, small refinancing and guarantees).

As far as **carbon asset portfolios** are concerned, UNEP FI and the World Resources Institute published in 2015 a discussion framework on carbon asset risk[11]. With the change in public priorities, and the move by governments to enact sustainable policies, some investors and stakeholders are questioning whether loans or investments in carbon-intensive physical assets or companies could be at risk of changes in policy, technology, market, economic or social trends. UNEP FI and WRI have devised a conceptual framework to help financial intermediaries and investors think more consistently and systematically about carbon asset risk. The framework could enhance users' current risk management processes to ultimately strengthen their overall decision-making. As stated in the report, a financial intermediary or investor cannot be exposed to carbon asset risk unless the underlying operator with which it has a financial relationship is exposed to carbon risk. There could be instances where an operator is exposed to carbon risk but a financial intermediary or investor faces very little carbon asset risk. This could stem from the type of financial relationship at hand (for example, a loan versus an equity investment), as well as the expected duration and liquidity of the position. The report recommends that, due to the uncertainty of what direction future direction of public policies will take, the financial sector should help to reduce this uncertainty by working with policy makers and specify a timeline for the goals being set. This would give financial intermediaries and investors the ability to assess and manage carbon asset risk.

It is necessary to highlight the lack of a link between the carbon asset methods currently being developed based on investment decision support and those being developed from a competition investment angle. Countries such as Japan, America and China are developing their own carbon asset markets by giving financial value to low-carbon assets. This creates additional competition of the assets carried by these carbon asset mechanisms.

[11] http://www.unepfi.org/fileadmin/documents/carbon_asset_risk.pdf

The Energy Efficiency Financial Institutions Group (EEFIG) have created the De-risking Energy Efficiency Platform (DEEP), a pan-EU open-source database containing detailed information and analysis of 6000 energy efficiency projects (please note that the platform is not yet launched, but will be in the coming weeks). It aims to be a user-friendly, transparent and open source evidence base for EU financial investors to use when looking at entering into the energy efficiency markets. The DEEP currently focuses on major projects (public buildings, industrial buildings, etc.) and therefore mainly concerns asset managers. It must facilitate the confidence of these actors to massify investments in the field of energy efficiency until they can create energy efficiency asset classes, as in the case of renewable energy. For instance, BPCE will integrate in this database 1000 energy efficiency projects of individuals financed in France to broaden the range of projects and show the types of projects where retail banks can invest.

The findings of the EEFIG work resulted in 2 tools. The first one called 'underwriting' aims to create a directory of the best financing mechanisms on energy efficiency that can serve as a breeding ground for the European Commission to introduce funding tools accompanying the upcoming revisions of the Energy Efficiency Directive and Energy Performance of Buildings Directive. Following the intervention of ESBG via its representative, underwriting will prioritise retail financing mechanisms.

2. With whom can local banks work? What can be done by others?

- Need for private/public partnership

Huge and long-term investments (according to Bloomberg, new energy finance was worth 320 billion dollars in 2015 and 12 000 billion dollars will be needed worldwide by 2040, i.e. 485 billion dollars per year in a voluntarist scenario) are needed in renewable energy, transport and energy infrastructure, buildings, industrial processes and new technologies. Given the constraints on public finance in many countries in the world, the largest part of these investments will have to be financed by the private sector: most of the investment will have to come from private households and SMEs. The public sector has also its role to play and can help via selective fiscal incentives and public guarantees (for instance, in Europe, the Juncker Plan in the EU will make at least 30% of its commitment in the "green sector"). This challenging goal, as stated by Governor Carney in his speech "Breaking the Tragedy of the Horizon - climate change and stability" on 29 September 2015, could maybe be achieved through the cooperation of the public/private sector under the impetus of the G20. In a nutshell, much could be achieved through the cooperation between different actors who invest in order to make real the transition to a low-carbon economy.

The amount of these investments could lead to the temptation of a massification through capital markets. However, the competition factor should not be neglected as the EU is not necessarily able to lead the process of energy transition; it is illustrated by the decrease of assets under management from 62% to 52% which corresponds to 20 billion dollars of investment transferred to Asia and the US at the detriment of the EU. The other alternative in order to reach a massification of these investments consists of promoting the actors who support economic growth in the EU, namely SMEs with their capacity in terms of innovation and distribution channels.

As a result, local banks should increasingly cooperate with municipalities in order to organise the financing of new markets in particular on green economy (in particular one on energy efficiency). The European Commission has promoted such cooperation through the programme ELENA-KFW which should be widely spread out.

For instance, organisational structures could be put in place in view of fostering cooperation led by regions, such as the existing regional layers, some of which taking the form of committees, composed of the different actors involved in the project.

- Essential role of the public sphere

The public authorities also play an essential role from a **regulatory perspective**. It is essential that governments have clear objectives whilst increasing sustainability practices and greening the economy, in particular through tax incentives (e.g. carbon tax). Public authorities can also fund sustainable facilities within their communities, for example carbon-neutral public transport, comprehensive recycling systems and additional green spaces in the form of public parks.

In addition, in case **prudential incentives** could not be granted (for instance, 9% decrease in RWA on SMEs green loans), transparency in the form of green ratios could be a way forward. In particular, savings banks believe that the current legislation should be altered to incorporate green indicators or environment certificates, but special attention should be paid so as not to increase the regulatory burden. For this reason, there should be an incentive for banks to invest in sustainable projects, rather than prohibiting them from unsustainable investments.

A certain harmonisation of definitions and **labels of green products** should be ensured (including for insurance products which guarantee the quality and efficiency of the energy works), which should be discussed between the private sector and regulators/supervisors; to make the green ecosystem more organised and more scrutinised would reinforce its credibility and efficiency.

The incentives given to local banks should be accompanied by the **promotion of credit lines** linked to energy efficiency for local enterprises.

Specific financial resources dedicated to the innovative green sector, in particular the renewable energy for which the demand for finance is high, should be developed. To do so, central bank or regional investment bank financing could be used, as well as a guarantee fund.

The creation of a **green guarantee fund** (0% rate) which would guarantee 70% of the amount of the green loan could be envisaged, set up with a general budget and not project by project in order to simplify banking intervention. Why not reactivate the European Investment Fund programme "Growth and Environment" which was active from 1996 to 2002? - It was free and guaranteed 50% of the loans. The creation of a green guarantee fund (0% rate) which would guarantee 70% of the amount of financing linked to energy efficiency could also be envisaged for joint ownerships. It would enable to develop third-party financing, and would transform the indebtedness of co-owners into a green cost. A fund which would contribute to reinforcing the own funds of local banks which invest in green financing could also be created. The Global Alliance for Banking on Values (GABV) set up such a fund known as SFRE (Sustainability Finance Real Economies, *pronounced Sapphire*), the "first global open-ended investment umbrella fund developed to deploy substantial amounts of long term capital to support a broad range of banks with a proven track record of serving the real economy by meeting the needs of individuals, enterprises and communities they serve whilst also delivering robust and stable financial returns".

- The role of investors

Sustainable, responsible and impact (SRI) investors are both individuals (from average retail investors to very high net worth individuals and family offices) and institutions (universities, foundations, pension funds, non-profit organisations and religious institutions). There are hundreds of investment management firms that offer SRI investing funds and vehicles for these investors. Owning shares in a company gives investors a channel through which to raise ESG issues of concern, and active shareholders are able to bring important issues to the attention of company management and to the general public.

Recent social and environmental resolutions have addressed equal employment opportunities, climate change, human rights and sustainability reporting. In addition, investors have filed resolutions questioning companies on their governance structures and practices, particularly those involving board composition, executive pay and responsiveness to shareholders. In recent years, these proposals have been gaining traction, and frequently receive majority support.

About ESBG (European Savings and Retail Banking Group)

European Savings and Retail Banking Group – aisbl
Rue Marie-Thérèse, 11 ▪ B-1000 Brussels ▪ Tel: +32 2 211 11 11 ▪ Fax : +32 2 211 11 99
Info@wsbi-esbg.org ▪ www.wsbi-esbg.org

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