Deutsche Bank position paper: incentives for sustainable finance

Introduction

- Europe's businesses are heavily reliant on bank financing: In 2018/19, 62% of the financing infrastructure in the euro area consisted of banking sector assets. Only 10% of EU-27 companies' new funding came from capital markets.[1]
- The definitions of a sustainable activity / asset are still under development. The EU Taxonomy Regulation will only cover some parts of sustainability (climate change in the first instance), and it will not extend to sustainability-linked loans.
- Pricing for sustainable loans and project finance is subject to uncertainty. When a new sustainable technology is being developed (e.g. an energy-efficient battery), there is no historic reference data to support its credit case. As the 2019 survey by the Network for Greening the Financial System (NGFS) found, there is no methodology in place at present to track a potential risk differential between 'green' and 'brown' assets.[2]
- Finally, where there are frameworks for sustainable products, the attached assessment and transparency requirements often make the 'green' product more expensive than the mainstream choice.
- The need to grow investments in sustainability now means we cannot wait for these market failures to self-correct. Therefore, some targeted regulatory interventions are justified and necessary.

Prudential incentives

- ESG incentivisation factors should be incorporated into the prudential (pillar-1) framework for banks. There are two potential cases that can form the basis for inspiration for RWA adjustments: CRR Art. 501a [Infrastructure factor] or the "high quality" criteria for Specialised Lending in the Final Basel III rules (CRE20.52).

- Taking CRR Art. 501a as a model, a set of definitions can be designed as follows:
  1. Capital requirements for credit risk calculated in accordance with Title II, Part III 269 shall be multiplied by a factor of 0.75 provided the exposure complies with all the following criteria:
  (a) the exposure is included either in the corporate asset class or in the Specialised Lending exposures class, with the exclusion of exposures in default;
  (b) the exposure is to a specific to lending, project finance and investments to finance or operate structures or facilities, systems and networks that
    i) make an essential contribution to Regulation (EU) 2018/1999 (European Climate Law), or
    ii) are sustainable, as provided in the criteria of the EU Taxonomy Regulation for sustainable activities, or

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[1] Data from IMF Staff Discussion Note, A Capital Market Union for Europe, published in Sep 2019, p6; and Association of Financial Markets in Europe (AFME): Capital Markets Union, Key Performance Indicators, published in Oct 2019, p13.

[2] See NGFS "Status report on financial institutions' practices with respect to risk differential between green, non-green and brown financial assets and a potential risk differential", published on 27 May 2020.

iii) are fully covered by the EU Green Bond Standard and/or another recognised market standard, e.g. ICMA Green or Social Bond Principles[3] or the Loan Market Association's Green Loan Principles / Sustainability Linked Loan Principles [4].

(c) the primary source of repayment of the obligation is the income generated by the assets being financed, rather than the independent capacity of a broader commercial enterprise;

(d) the obligor can meet its financial obligations even under severely stressed conditions that are relevant for the risk of the project;

(e) the contractual arrangements provide lenders with a high degree of protection.

2. Institutions shall report to competent authorities every 6 months on the total amount of exposures to sustainable project entities calculated in accordance with this Article.

- The "high quality" criteria for Specialised Lending in the Final Basel III rules[5] could equally serve as a template. In analogy to this the following parameters may define a "sustainable loan/project":
    - Refers to an exposure that is advancing the sustainability targets of the EU, i.e.:
        - Fulfils the criteria of the EU Taxonomy Regulation for sustainable activities, or
        - Fulfils the criteria of another equivalent non-EU taxonomy, or
        - Is covered by a recognised market standard, e.g. ICMA Green / Social Bond Principles or the Loan Market Association's Green Loan Principles / Sustainability Linked Loan Principles.
    - The following conditions must also be met:
        - The originator needs to evidence compliance with the above and ensure transparent disclosure.
        - There needs to be independent, external verification.
        - The usual risk assessment criteria apply and have been applied before the exposure is classified as sustainable.

- To ensure that such finance instruments are not hindered by other, non-risk-sensitive prudential requirements, the leverage ratio requirements should also be adjusted for these exposures.

Green / Sustainability-linked Bonds

- To support the growth of green and sustainability-linked bonds, the higher cost for the issuer due to heightened transparency requirements should be alleviated.

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[3] All ICMA principles and guidelines as well as their governance frameworks are available at https://www.icmagroup.org/green-social-and-sustainability-bonds.

[4] See https://www.lma.eu.com/documents-guidelines/documents/category/green--sustainable-finance#green--sustainable-finance138 for more details.

[5] Basel Committee: CRE - Calculation of RWA for credit risk. CRE20 - Standardised approach: individual exposures, section 20.52. https://www.bis.org/basel_framework/chapter/CRE/20.htm?inforce=20220101

- Therefore, issuers should be able to receive a targeted compensation payment for the costs of having to report on the use of proceeds and the independent verification.
- The Monetary Authority of Singapore's Sustainable Bond Grant Scheme provides a model, as it is targeted and time-limited until 2023.[6]

Green securitisation

- Securitisation provides an opportunity to relieve banks' balance sheets and to offer investment opportunities. The EU has been working on new rules to allow a credible restart of securitisation markets, by creating a specific framework for high-quality Simple, Transparent and Standardised (STS) securitisations.
- There should also be a legal framework for green securitisation: a) Criteria for assets to qualify as green assets; b) These assets should be eligible under the EU taxonomy and/or to include but not limited to: mortgages to finance energy-efficient homes, electric vehicle loans/leases, solar leases, SME loans to fund environmental projects, financing of corporates with a high ESG standard, etc.
- Securitisation which is not purely 'green' but could be classified as 'transition' may also have a role to play in dealing with ESG risks: Banks may be invested in assets seen as unsustainable in the long term. The transfer of such assets from banks to a wider pool of investors will overall result in a more efficient distribution of risk of legacy assets throughout the financial system. If such transactions brought an incentive for the use of proceeds to be invested in sustainable investments and activities, then the financial sector can be the driver of the transformation of legacy 'brown' assets to greener balance sheets.
- Banks should be able to obtain a beneficial capital charge and liquidity value when investing in securitisation referencing green assets. (Re)-insurer should also get a beneficial capital charge when investing in securitisation referencing green assets. Green assets should allow for both economic (lower carbon emission) and wider environmental benefits (less pollution, biodiversity).

Guarantees

- All of the above projects will take months, if not years to be developed and, if necessary, legislated. Therefore, short-term action is also required.
- We have seen a widening of governmental support and guarantee schemes during the Covid-19 crisis. We can learn from this experience and build on long-standing systems such as export finance guarantees. To provide quick support for scaling up sustainable financing, existing loan guarantee and export finance schemes should be adapted to provide guarantees (of up to 80%) for bank loans supporting sustainable projects and transitioning company's business models.
- This could also include direct guarantees provided by EIB and/or regional promotional institutions or creating a new fund.
- To incentivise large investments in sustainable projects, the EU should set up a long-term investment fund to support the Green Deal. This fund can back up loans for companies making large-scale investments in sustainable technologies or, with clear conditions, strengthen the equity base for a company advancing sustainability. Ottmar Edenhofer, director of the Potsdam Institute for Climate Impact Research has suggested such as fund, which would be able to refinance

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[6] See https://www.mas.gov.sg/schemes-and-initiatives/sustainable-bond-grant-scheme for more details.

itself on favourable terms on capital markets, as it would be backed by EU member states.

- In addition to Prof Edenhofer's suggestion, this fund could also accept private-sector capital to act in partnership for its projects.