



EUROPEAN POLICY BRIEF



FINANCIALISATION ECONOMY SOCIETY AND SUSTAINABLE DEVELOPMENT

A European Union Sustainable Banking Network

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INTRODUCTION

This policy brief suggests a proposal for the promotion of a sustainable banking system in the EU. This sustainable banking network, that we suggest to call EU Sustainable Banking Network (EU SBN), aims to coordinate the actions of private and public banks towards sustainable banking principles through a system based on three pillars: green certification of financial intermediaries, green project rating and systematic monitoring.

There is a growing agreement that grave environmental issues increasingly jeopardize the sustainability of development. A rapid solution to these issues requires a huge steady flow of “green investment” improving the quality of the environment and avoiding the exhaustion of natural resources. A case in point is the massive investment required to speed up the mitigation of global warming and the adaptation to its ongoing consequences. According to authoritative research centres, the amount of current private investment is roughly one third of the investment needed. In the absence of adequate incentives provided by public

policy, the private contribution to required green investment is bound to be insufficient. The inability of current financial markets to prioritize sustainable investment and reduce support to polluting activities depends on two main structural reasons: short-termism and high risk aversion. The returns of green investment are visible only in the long run and are often subject to strong uncertainty. The returns of path-breaking eco-innovations are particularly uncertain.

To bridge the green investment gap, the obvious solution seems to be the integration of the missing private investment with public investment. There is no doubt that the government should play the role of “investor of last resort” whenever green investment is urgent and the private initiative is insufficient. However, public investment has its own shortcomings. The required increase of public expenditure is hardly implementable by heavily indebted countries. In addition, particular interests, inefficiency and corruption may distort the choice and management of public investment. Therefore, public policy should aim to stimulate private investment and promote a constructive synergy between private and public investment. In particular, public financial institutions may play an important role to support and foster sustainable projects in partnership with private finance. The international public debate on climate finance is increasingly recognizing the importance of publicly capitalised banks to back the transition to a sustainable economy.

In Europe, some public banks have already undertaken several important measures towards green finance. We recommend scale-up and improving the current initiatives by creating a network of European public and private banks, under the coordination of a European-level institution to promote sustainable banking policies, guidelines and practices. We call this system European Sustainable Banking Network (EU SBN). Our proposal relies on three main co-ordinated actions: 1) green certification of private and public financial institutions, 2) sustainability rating of project proposals, and 3) systematic monitoring of the performance of banks and investment projects financed.

This network may ensure a systematic application of sustainable banking criteria to investment blueprints; it may provide a strong signal for policy commitment, and it may optimize the allocation of public and private funds for sustainable projects.

Public banks engaged in sustainable banking practices

Around the world, several national and subnational governments have created public green investment banks. Europe is also participating in this trend with, for instance, the recent setting up of the British Green Investment Bank. At the same time, some European public banks, which have been operating for many years, have committed themselves to base their investments and banking services on sustainability. The German development bank KfW is an example of state-owned bank that has prioritized environmental-friendly projects in its asset allocation decisions. Similarly, at least seven members of the European Association of Public Banks (EAPB) explicitly identify promotion of environmental protection, energy efficiency and renewable energy as priority of their mission. Several of them, especially Scandinavian public banks, adhere to corporate social responsibility principles and publish reports on their approach to sustainability. At the European level, we can mention the European Investment Bank (EIB) that has put climate action among its priorities. Moreover, the EIB manages the European Fund for Strategic Investments (EFSI), a €16 billion (recently increased) guarantee from the EU budget, to finance and mobilise resources for investment in priority areas, including transport and energy infrastructures and expansion of renewable energy systems and resource efficiency.

All these examples suggest that European public banks are ready to take on the challenge of mobilising and scaling up green investments but their actions are not coordinated. In addition, social and environmental monitoring of loans and investment decisions need to be improved.

The European financial institutions owned or sponsored by member countries' governments have been playing the important role of reducing the so-called "green finance gap" but the results obtained are insufficient. Therefore, the present efforts of sustainable banking need to be strengthened and adjusted.

In the next section, we formulate a proposal for building a European system of public sustainable banking. This approach is based on:

- 1) a coordinated and monitored network of institutions,
- 2) an active and green-oriented engagement of national and private banks, financial institutions or funds.
- 3) a comprehensive notion of sustainability, which considers the complexity and the multifunctional nature of the environment.

A further and more ambitious step along a path already started

This section discusses how the EU might establish a sustainable banking system overcoming the current limits of green finance through a banking network involving a large number of agents with different functions, competences, and resources. The aim is to reinforce the coordination among the European public and private banks and to orient them towards environmental and social principles. The creation of a European network of banks is in line with recent orientations of the European Commission. We advocate a further and more ambitious effort by creating what we call EU Sustainable Banking Network (EU SBN) based on bank certification, project rating and systematic monitoring.

The core of the EU SBN

This network articulates in three parts: a core of public sustainable banks, a cloud of private certified financial partners, and a central entity that promotes monitors and coordinates the network. The core comprises public banks having the mandate of financing green and sustainable investment. We do not need to define a unique standard model of core bank, admitting instead in the network a large spectrum of options. At one extreme, we have the case of green investment banks (GIBs) with an exclusive focus on green investment (as the British GIB established in 2012); at the other extreme, we have the case of national development banks (NDBs) with a larger scope including environmental sustainability (such as the Germany's KfW). Each EU country may designate national core banks choosing the preferred model within this spectrum. Member States without this type of institutions may consider creating a new one. The acceptance in the network is conditional to the compliance with a few basic sustainability principles and a clear commitment to realise the sustainability objectives set by the EU. However, each core bank maintains in the network a high degree of independence in day-by-day decisions.

The role of a core bank ranges from directly investing in green projects to removing the obstacles to private green investment. In particular, for example, a core bank can reduce the transaction costs and the risk of green investment by co-investing to provide sufficient scale or expertise, by leasing real assets to split the costs in many instalments, by aggregating small projects to realize scale economies, by allowing borrowers to repay loans through an additional charge to their utility bill.

The rationale of a core bank is that of using small amounts of public funds to mobilise larger amounts of private capital (green investment leverage). Public funds may come, for example, from carbon tax revenue, emission-trading schemes, reallocation of the funds currently incentivising carbon fuels, or utility bill surcharges on energy use. The core bank's funds may come not only from national government or local administrations but also from directly

accessing financial markets, in particular by issuing green bonds. Setting up an integrated system of national public banks may contribute to strengthen the capacity to collect funds from other parties and from international financial markets.

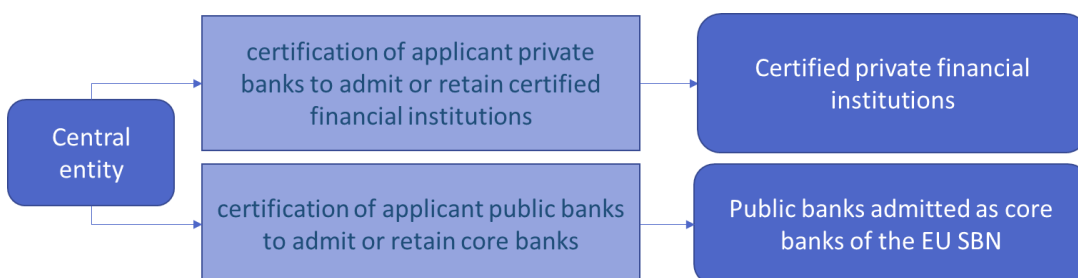
Certified private partners

As mentioned above, the network comprises also certified private banks. The existing public green banks are already directly collaborating with private investors. Examples include co-investment with particular institutional investors, community banks and local contractors, delivery of targeted loans to project developers and individuals (e.g. for the installation of retrofits and solar rooftops). However, we suggest that public funds and incentives should be shared only with private banks observing strict principles of sustainable banking, transparency and accountability (CSR and ESG), namely on a set of certified private banks (see below the first pillar of the network). Sustainability principles include (i) credit allocation aiming to promote resilience, environmental protection and human development; (ii) transparency and inclusiveness in governance; (iii) effective reporting and disclosure on financial and non-financial impacts; (iv) development of internal expertise, skills and capabilities on sustainability; (v) incentive structures and remuneration schemes aligned to long-term and sustainability considerations.

Central Entity

The EU SBN network is managed by a central entity that regulates admission or exclusion of core banks and private partners to this system. The central entity elaborates sustainability standards, and keeps a public registry of the core banks and certified private financial institutions that are compliant with these principles (Figure 1). In addition, the central authority coordinates the elaboration of common EU guidelines for assigning merit scores to the investment projects. Through these functions, the central authority ensures a coherent guidance on EU sustainable finance and a stable and consistent interface with EU policy strategy and targets.

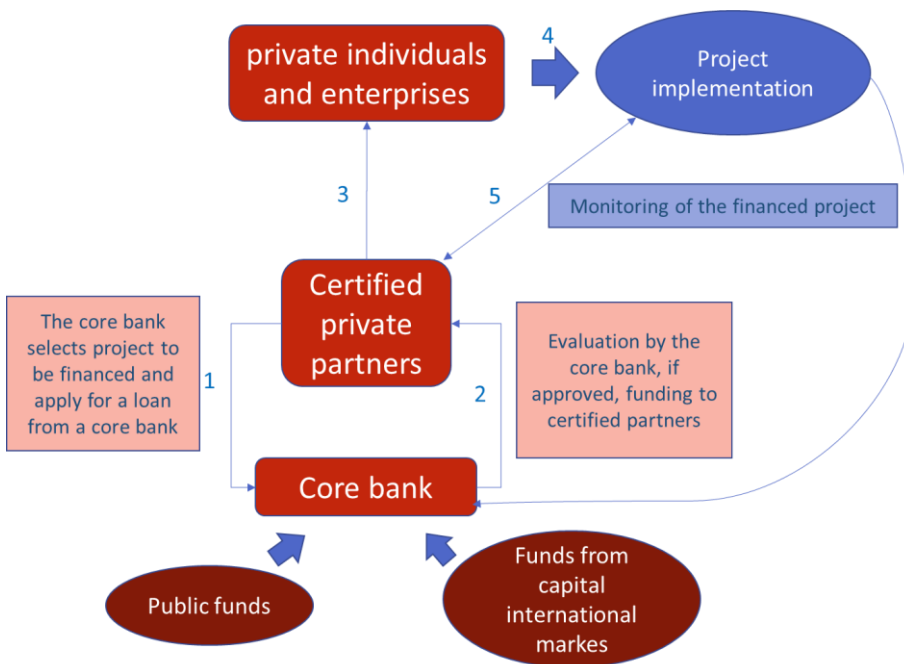
Figure 1. Certification of core public banks and private financial institutions



Project proponents (private investors, firms but also public entities such as local governments) may apply for direct support from a core public bank or for indirect financing by certified intermediary banks. In the first case, the core public bank assesses and selects the projects. In the second case,

private banks may evaluate the project and choose whether to apply for a loan from the core bank. The core bank, then, should decide whether to approve it and supply funds to the certified private bank (Figure 2). Here we concentrate on traditional lending activity, but this system may also apply to the provision of other banking services aiming at removing the barriers to private green investment such as risk covenants (e.g. risk-sharing, partial loan guarantees, and loan loss reserves) and transaction enablers which reduce transaction costs (e.g. investment platforms, warehousing). In order to attract private capital and increase their eventual recovery rate, the core of public banks should indeed deliver a set of guarantees or collateral. Private equity operations may be also particularly important financial instruments to support projects in the first and riskiest phase of their life. In this way, the public sector accepts to be exposed to the high default risk of early stage initiatives, without originating any contagion risk through debt instruments.

Figure 2: Spreading out sustainable banking through intermediary financial institutions



The three pillar of the network

This system is based on three pillars:

1. **Sustainability certification of financial intermediaries.** The access to public funds for sustainable investments should be restricted only to those banks and financial institutions that are included in a specific public registry.
2. **Sustainability project rating.** Projects funded or co-financed by public resources are selected according to a score attributed by the core banks. The central agency

elaborates criteria for selecting and financing directly the most promising green projects and provides guidelines for scoring methodologies. They should decide allocation of their credit according to criteria following not only common European guidelines but also specific national needs and environmental priorities.

3. Monitoring. Supported projects should be subject to a process of monitoring both in the phase of implementation (in order to introduce corrective measures) and ex-post (in order to promote institutional learning and to assess the final economic, environmental and social impact of the projects financed).

The accountability of core banks should be monitored through apt metrics. The financial metrics should adopt long-run criteria of profitability for all the stakeholders, and specific financial rates such as the “green investment leverage”, namely the ratio between private capital mobilised and public capital. The financial metrics should be evaluated in the light of a congruous set of sustainability metrics such as GHGs emission saved, energy saved, job creation.

Why a network? Potential advantages of the EU SBN

This system might have a number of advantages and contribute to create a sustainable banking system in various ways:

1. It can provide incentives to EU public banks to pursue social and environmental benefits and sustainability. At the same time, the system can stimulate virtuous competition among private banks in order to get access to public funds and to services of the core public banks.

2. The combination of authorized financial institutions and rated projects along with systematic monitoring can improve the allocation of resources for sustainable development.

3. The simultaneous engagement of a number of public and private banks across EU countries under a same system could ease the realization of a joint and coordinated strategy and can be a driving force for overall financial markets. The effect may be a relevant scaling-up of credit, technical and guarantee support for sustainable investment.

4. This system can leverage network opportunities. The EU-SBN can become a crucial instrument to disseminate, promote and coherently coordinate the application of sustainable banking principles as well as to share experience and expertise. Moreover, it might foster the diffusion of systematic and standardized methods, within the banking system, for monitoring and reporting information on economic and technological sustainability, financial performance and social-environmental impacts of financed projects and transactions. Finally, it can favour consortia for transnational, or particularly ambitious, projects.

5. The EU-SBN will improve market confidence in green, sustainable and socially desirable investing. To the extent that the EU-SBN can enhance exchange of information, technical assistance and investor confidence on sustainable investment, it can also promote credit demand for these projects.

What central entity? The EIB or a new institution?

The central entity for this system can be established by setting up a new entity or by selecting and reforming an EU-level existing banking institution. The first option has some advantages: (i) changing the culture of an existing public bank is likely to encounter opposition; (ii) avoiding the inconsistency of existing “non-sustainable” projects. However, the creation of another EU entity may encounter problems of overlapping of functions, reduction of assigned human and financial resources, increase in transaction and coordination costs, conflicting actions across agencies involved in similar activities.

A possible alternative is therefore to select an existing institution entrusting the task of central authority of the EU-SBN. In Europe, the natural candidate for this role is the EIB, the public bank of the European Union, which already performs key roles and functions in existing EU initiatives to finance sustainable development. The reform of the EIB into a sustainable bank and its transformation into the central entity might present a number of advantages:

- *Scale effect.* The EIB has already a considerable capacity to mobilise both public and private resources, as it is the largest multilateral lender and borrower in the world. Its involvement as leading entity in the EU SBN could produce an important scale effect.
- *Exploitation of existing expertise:* the EIB has already gained an important experience in financing and supporting green projects and applying Environmental, Social and Governance (ESG) Criteria.
- *Capacity to leverage a well-established and extended network and to “mainstreaming” sustainability.* The EIB has simultaneous relations with public actors, large banks and financial operators and its activity addresses – directly or through a network of partners – clients of all size. Moreover, it has an established position as a borrower, lender and provider of advisory services in several economic sectors. It is able to provide different services, from lending to technical assistance. Finally, the EIB already leads a joint working group, with the participation of the European Commission, to enhance cooperation with other national promotional banks. In particular, in 2015, eight countries have announced that they will participate in the EFSI project via their national promotional banks. Finally, the EIB, as potential central entity of the EU-SBN is well placed to operate in partnership with other EU public banks (for instance the EBRD) or other associations of financial institutions and banks.

- *Involvement of other EU funds, tools, and initiatives managed by the EIB group.* The choice of reforming the EIB as central entity would allow including and subsuming other products of the bank into the proposed mechanism. A particularly valuable contribution would be its application to the EFSI and other EIB instruments such as InnovFin. At the same time, the inclusion of environmental and social drivers into advisory services of the EIB, such as the European Investment Advisory Hub (EIAH), could be strengthened. In this way, the Investment Plan could be strictly mission-oriented towards a transition to sustainable economy in its main pillars, the EFSI and EIAH.
- *Coherence with EC policy priorities and sustainability targets.* Along its history, the EIB lending policy has responded to policy priorities set by Member States and the EU Commission. As EU-level institution could act in strict coordination with other EU agencies including those in charge of monitoring the main existing and expected environmental challenges, such as the European Environmental Agency (EEA).

Concluding remarks

The establishment of an EU SBN network could help bridge the green investment gap and promote a more effective transition towards a sustainable trajectory. This proposal combines different approaches to reach this difficult but urgent goal combining insights from finance, public economics, and CSR theory. The basic philosophy underlying this proposal aims to overcome the barriers to private green investment by exploiting the synergies between public and private investment as well as between CSR self-regulation and legal regulation.

RESEARCH PARAMETERS

The research programme will integrate diverse levels, methods and disciplinary traditions with the aim of developing a comprehensive policy agenda for changing the role of the financial system to help achieve a future that is sustainable in environmental, social and economic terms. The programme involves an integrated and balanced consortium involving partners from 14 countries that has unsurpassed experience of deploying diverse perspectives both within economics and across disciplines inclusive of economics. The programme is distinctively pluralistic, and aims to forge alliances across the social sciences, so as to understand how finance can better serve economic, social and environmental needs. The central issues addressed are the ways in which the growth and performance of economies in the last 30 years have been dependent on the characteristics of the processes of financialisation; how has financialisation impacted on the achievement of specific economic, social, and environmental objectives?; the nature of the relationship between financialisation and the sustainability of the financial system, economic

development and the environment?; the lessons to be drawn from the crisis about the nature and impacts of financialisation?; what are the requisites of a financial system able to support a process of sustainable development, broadly conceived

PROJECT IDENTITY

PROJECT NAME Financialisation Economy Society and Sustainable Development (FESSUD)

COORDINATOR University of Leeds, UK: email fessud@leeds.ac.uk

CONSORTIUM University of Siena, Italy
School of Oriental and African Studies, UK
Fondation Nationale des Sciences Politiques, France
Pour la Solidarité, Brussels, Belgium
Poznan University of Economics, Poland
Tallin University of Technology, Estonia
Berlin School of Economics and Law, Germany
Centre for Social Studies, University of Coimbra, Portugal
University of Pannonia, Veszprem, Hungary
National and Kapodistrian University of Athens, Greece
Middle East Technical University, Ankara, Turkey
Lund University, Sweden
University of Witwatersrand, South Africa
University of the Basque Country, Bilbao, Spain

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WEBSITE fessud.eu

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FURTHER READING Gabbi, G., and Ticci, E. 2014. Implications of financialisation for sustainability, Working Paper Series No. 47, August 2014, available at <http://fessud.eu/working-papers/#WP7>

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