GREEN FINANCE AS A SERIOUSLY TAKEN ISSUE OR A PR GAME?

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Agenda

1. Introduction
2. Premium for a green bond
3. Performance of sustainable funds
4. Green supporting factor
5. Conclusion

Introductory notes

- Climate change is a global challenge that demands global solutions (different views from different stakeholders)
- Action needed but the devil is in the detail (taxonomy etc.)
- Carney (2015) describes the potentially severe impact of climate change on the economy as a “tragedy of the horizon”
- Myopic investors and other actors do not sufficiently take the risks into account as they materialize only over a long horizon (short-termism of their behavior / a PR game)
- Three theoretical questions to be answered

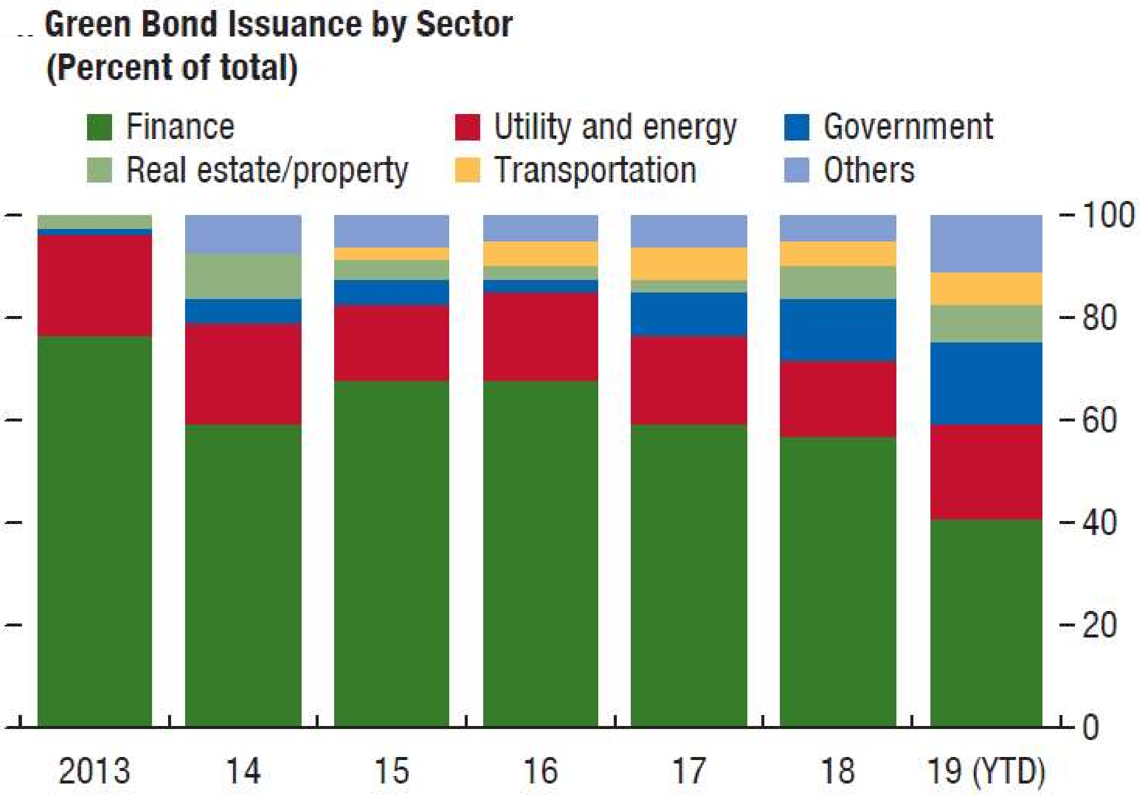
1) Are investors willing to pay a premium for a green bond (accept a lower spread)?
2) Do sustainable funds regularly underperform global equity funds (because of their higher risk)?
3) Can a ‘green supporting factor’ enhance higher banks´ funding of green projects?

Basic terms

- Sustainable finance = the incorporation of environmental, social, and governance (ESG) principles into business decisions, economic development, and investment strategies
- 2017 - The Network for Greening the Financial System (NGFS)
- 2018 - EU High-Level Expert Group on Sustainable Finance
- Green bonds are fixed-income instruments that finance green projects with an environmental objective (Jakubik and Uguz, 2019)
- Why to issue green/social bonds?
  a. Publicity (statement as good corporate citizen, highlight of issuer´s green assets/business)
  b. Economics (an increase of investor base with socially respossible investment funds; potential of a lower new issue premium due to higher oversubscription)

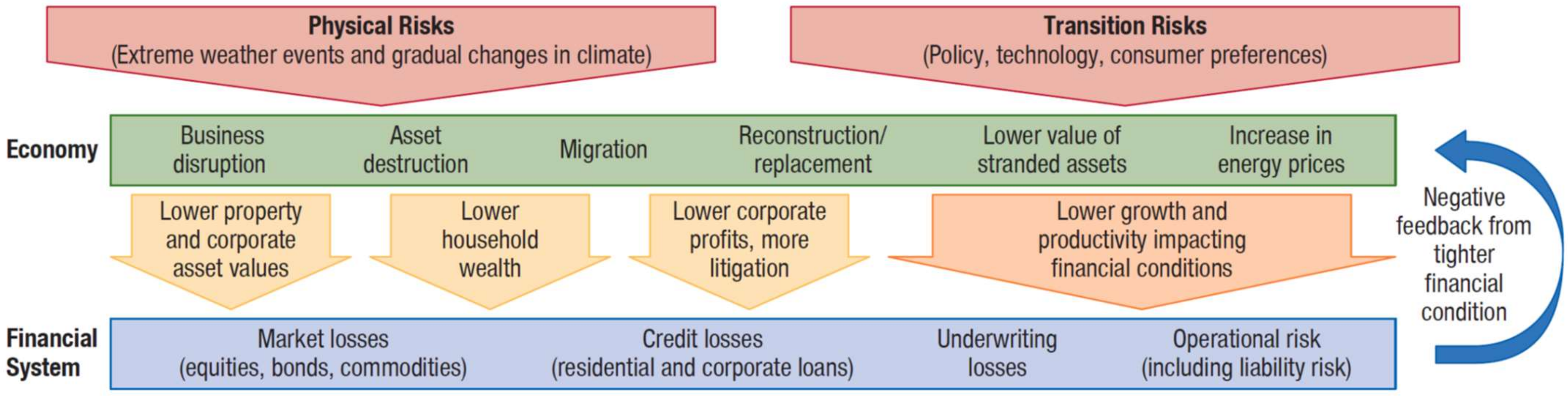
Global issuers of green bonds

- Green bonds´ issuance in 2019: cca USD 200bn (3% of total)
- Issuers of green bonds tend to be concentrated in a few sectors: finance, utility and energy, real estate/property, transportation



Source: IMF (2019). Global financial stability report. Chapter 6: Sustainable Finance International Monetary Fund, October 2019

Climate-related financial risks



- **Physical risks** arise from damage to property, land, and infrastructure from catastrophic weather-related events and broader climate trends;
- **Transition risks** arise from changes in the price of stranded assets and broader economic disruption because of evolving climate policy, technology, and market sentiment during the adjustment to a lower-carbon economy..

Source: IMF (2019). Global financial stability report. Chapter 6: Sustainable Finance International Monetary Fund, October 2019

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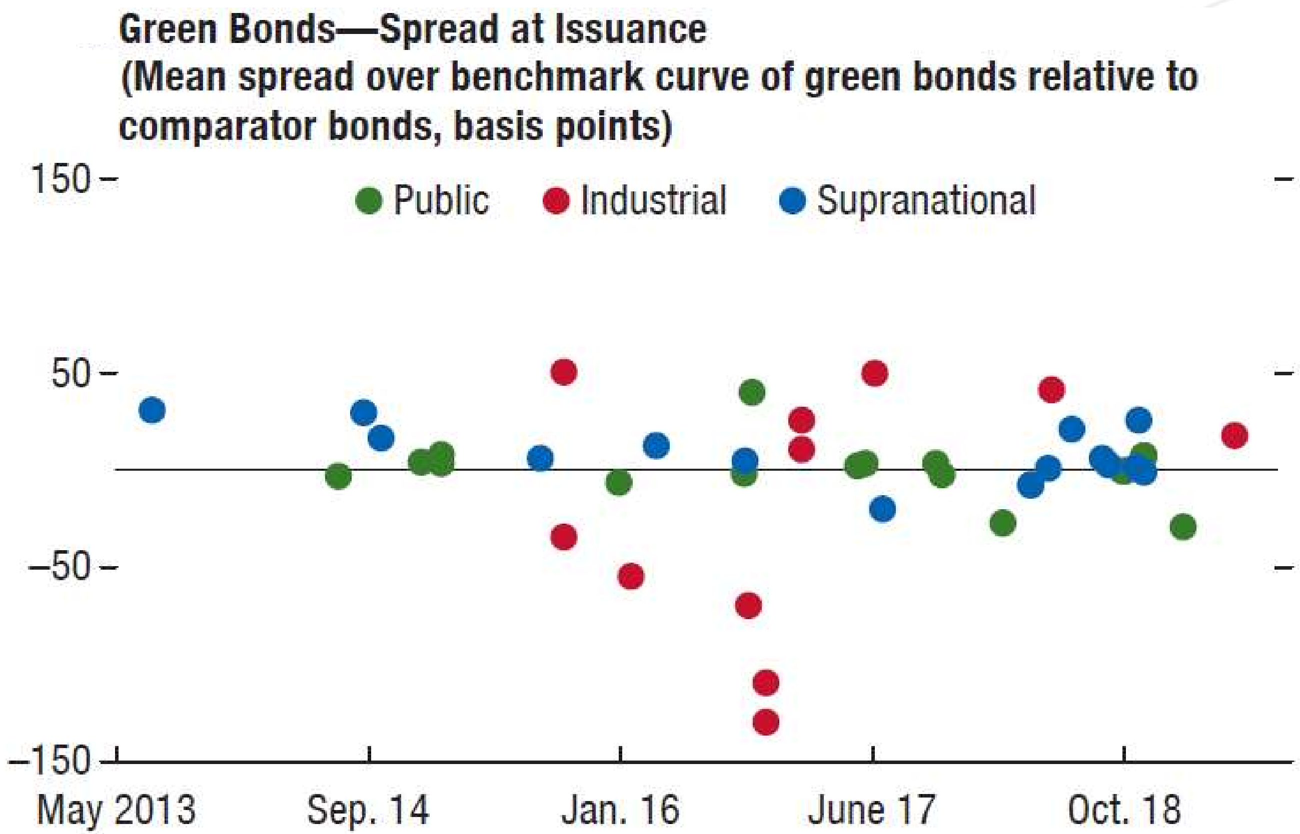
Answer 1: Investors are NOT willing to pay a premium for a green bond

- There is no consistent premium or discount at issuance between green and non-green bonds by the same issuer



Source: IMF (2019). Global financial stability report. Chapter 6: Sustainable Finance International Monetary Fund, October 2019

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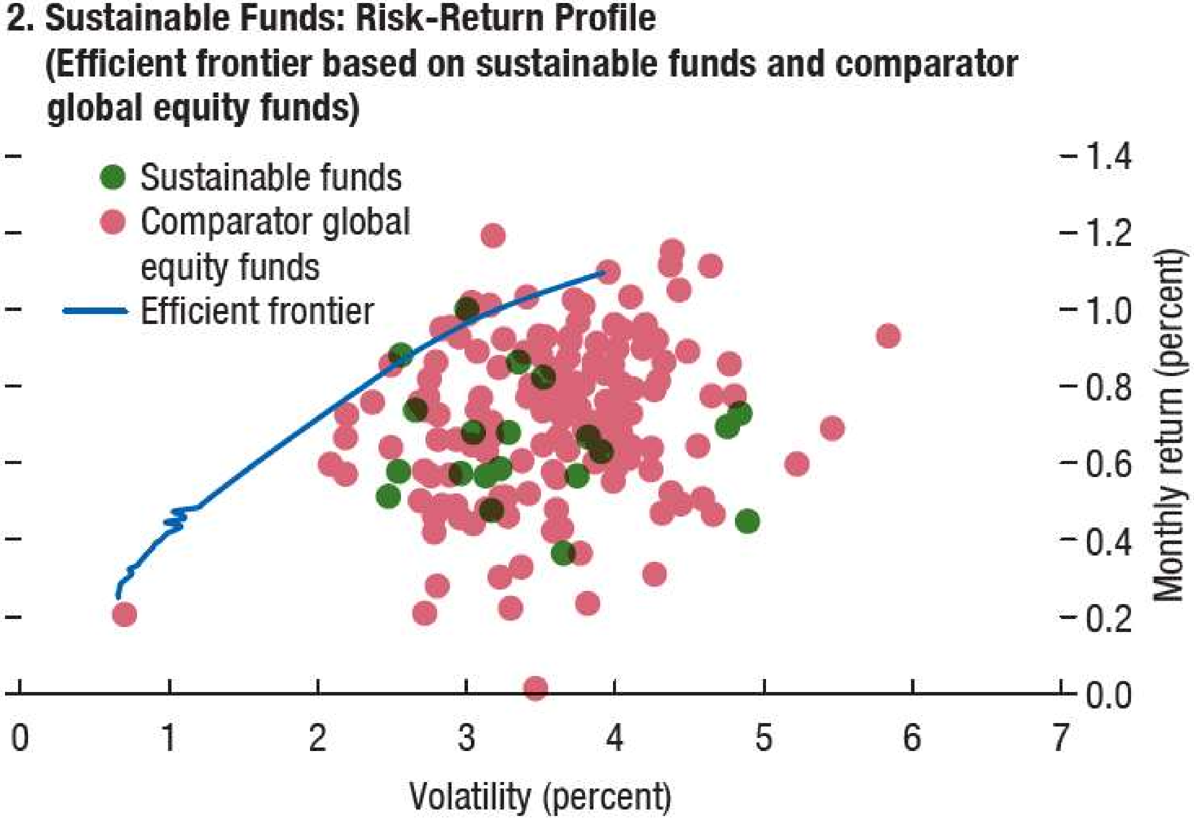
Answer 2: No consistent evidence that sustainable funds regularly over- or underperform global equity funds



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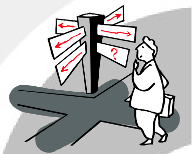

Challenges of climate-related risks for bankers

- The financial sector will play a crucial role in the transition towards a global low-carbon economy.
- However, the sector currently faces a challenge of how to value accurately the risks of such a transition.

False assumptions of financial risk analysis

1) That resources are infinite instead of limited and constrained;
2) That current technologies are stable and efficient instead of easily disrupted;
3) That client demand is entrenched in current technologies rather than shifting.

- The need of more accurately capturing, analysing and valuing risks in the lending and investing portfolios of fin. institutions.

Source: Godard, A. (2019). Fostering investment in sustainable projects, The Eurofi Magazine. September 2019

Three questions for bankers on climate-related risks

1) *Does the banking community have an accepted means of quantifying the climate risk in its portfolios?*
   - ➢ transition risks inherent in financing assets or business models that may become non-viable in the future
2) *Is the banking community properly equipped to assess new and emerging business models?*
   - ➢ linear banks (heavily exposed to “take, make, dispose” business model investments) vs non-linear risks
3) *Is the banking community fully aware of potential new risks embedded in “Paris-aligned” portfolios?*
   - ➢ To what extent a “Paris-aligned” portfolio is risk-proof? New risks are emerging...

- <u>The climate-related risks shall be reflected in banks´ capital</u> requirements to cover these risks

Source: Godard, A. (2019). Fostering investment in sustainable projects, The Eurofi Magazine. September 2019

Answer 3: A ‘green supporting factor’ could be risky

- Central bankers deal with two relevant issues
  - ✓ incorporating environmental sustainability objectives into central banks´ reserve management frameworks
  - ✓ green supporting factor for green & social assets of banks
- **Jens Weidmann, President of the Deutsche Bundesbank***
  - ✓ „…it would be wrong to want to use banking regulations to set climate policy incentives, for example by granting risk weighting “discounts” for “green” assets proposed by EU High-Level Expert Group (2018).
  - ✓ Capital requirements should always be geared to risk. Creating incentives to protect the climate, on the other hand, is a matter for politicians.
- **Marek Mora, Vice-Governor of the Czech National Bank**** recently expressed a similar opinion

Sources: * Weidmann, J. (2019). Climate change and central banks, conference speech, 29.10. 2019
** Mora, M. (2019). Spreading the "green good" is not our job“ [in Czech]. Lidove noviny, 31.10. 2019

Examples of regulatory failures (lower risk weights → lower banks´capital)

1) 35% risk weight for mortgages (Basel II)

- ✓ lower risk weight for mortgages (50% in Basel I) → banks were motivated to provide (subprime) mortgages but did not have sufficient capital, what fuelled the 2007-9 global financial crisis

2) 0% weight for domestic government bonds (Basel II)

- ✓ some Eurozone banks did not have capital cushion to cover losses from government bonds, what fuelled the 2010-12 Eurozone sovereign debt crisis

? Low risk weights for green & social assets

- ✓ uncertain impact – proper assessment of prudential treatment (green suppotting factor) for these assets needed
- ✓ negative lessons from previous regulatory failures

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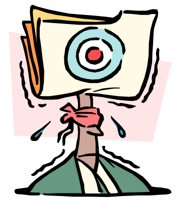
Conclusion

1) Finance is the key factor in the fight against climate change that either makes it or breaks it.
2) Investors are NOT willing to pay a premium for a green bond
3) Sustainable funds do not regularly underperform global equity funds
4) A green supporting factor could enhance higher banks´ funding of green projects but financial stability risks would increase
5) For some actors, green finance remains still a PR game rather than a seriously taken issue

Discussion



Thanks for your attention.
Let´s discuss it now!

Useful sources

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