

New pathways: Building blocks for a sustainable finance future for Europe

A white paper on financial sector reforms that could help
deliver a sustainable finance transformation in Europe



Contents

Foreword.....1

Introduction.....2

Executive summary3

Realigning finance with society5

Recalibrating regulatory instruments to encourage real stability.....9

A diverse financial ecosystem to grow a sustainable economy 13

Sustainable finance for all..... 17

Sustainability: the reason why finance should make money 21

Managing what matters most..... 23

Next steps 25

Foreword



Christiana Figueres, convener of Mission 2020 and co-chair of the Global Covenant of Mayors for Climate & Energy

When it comes to climate, timing is everything. We know that we have three years to safeguard our climate and our ability to create a prosperous world. Should greenhouse gas emissions continue to rise beyond 2020, or even remain level, the temperature goals outlined in the Paris Agreement become almost unattainable. The UN Sustainable Development Goals that were agreed in 2015 would also be at grave risk. To be prudent, we need to allow for a gradual decarbonization that avoids stranding major assets. For this orderly transition to take place while staying within the global greenhouse gas budget we need to reach the inflection point and start the global descent of emissions by 2020 - it's necessary, it's desirable, and most importantly it's achievable.

The transition to a carbon-free economy represents a most exciting opportunity for the finance industry, if the transition is jump-started in a timely manner. The role of leadership within the finance sector cannot be overstated. We need financial sector institutions and leaders - in Europe and across the world - to be partners in the global collaboration to co-create a new sustainable economy. The financial industry is uniquely placed to lead the way with a "business as urgent" operating principle.

Recent insights and research on the financial impact of climate change are already driving huge shifts within the finance industry. Carbon is increasingly recognized as a high risk asset whereas the new sustainable, clean and renewable industries are demonstrating that they hold the most promising opportunities. Following the trail of leaders on a mission within the sustainable finance movement, mainstream banks and investors are already pivoting towards a business model that recognizes the imperative of supporting society and the environment.

The proposals from the values-based banks, investors, academics and NGOs contained within this paper encapsulate the necessary ambition level and grounded feasibility which could contribute to accelerating the transition. I urge all those working within the finance sector and its regulation to give these recommendations the urgent consideration they deserve. With intentionality, ingenuity, and radical collaboration we can and we will reach the 2020 climate turning point.

Introduction



Peter Blom, Chair, Global Alliance for Banking on Values

The Global Alliance for Banking on Values has been dedicated to “finance change” since its foundation. Today, recognizing the scale of the challenges that face us in Europe and across the world, we want to increase the role we play in “changing finance”. Working together with leading thinkers, practitioners from a broad range of organisations connected to the sustainable finance agenda including Finance Watch, Mission 2020, Climate Action Network and the Sustainable Finance Lab,

we have co-created a number of tangible, realisable proposals based on our shared experience and a common vision for the future.

We believe that the finance sector can – and should – play a pro-active and leading role in the sustainability transition. Helping business and society to create solutions for the major sustainability challenges of our time is the value-creation model that should sit at the heart of every financial institution. In a European context, we can only make progress in creating meaningful, sustainable employment opportunities and appropriate infrastructure to help future generations thrive if we recast the purpose of finance: to meet economic, social and environmental needs together with all stakeholders so that their combined efforts flourish and contribute positively to the whole system.

For this transition to accelerate, we need to:

- Recalibrate the regulatory instruments used to ensure financial stability – in particular capital requirements – so that we take into account a more holistic view of the economy, society and environment upon which financial stability is predicated.
- Resolve the paradox of mismatches between finance and sustainable projects by cultivating a more diverse ecology of values-based, sustainable financial partners at a city, regional or national level, with a broad spectrum of risk appetites and sector specialities.
- Remove the diversions and boundaries that block individual citizens from investing in what they see as the best long term interests of the society where they live by opening up and enabling a healthy, regulated market in citizen impact investing.
- Reframe sustainability as the core leadership and value-creation opportunity for financial institutions of the future by encouraging training and competence in managing sustainability at every level.
- Reframe the goal of transparency as one which genuinely invites and enables stakeholders to understand finance, encouraging a focus on managing what matters most.

We welcome the chance to develop the proposals contained within this paper further together with interested parties and the various commissions and inquiries into sustainable finance. Many of these ideas have already been submitted as input to the European High Level Expert Group on Sustainable Finance who are due to report at the end of 2017, and we offer them now to all those who are empowered to act upon the proposals.

Executive summary

The proposals set out in this paper make the argument for specific tangible changes that financial institutions, financial regulators and policy makers can implement to deliver sustainable finance. They are clustered together in themes, each with their own briefing notes and recommendations to serve as building blocks in a renewed financial system.

The themes are, in broad terms, realigning finance with society's needs; recalibrating regulatory instruments; making the financial ecosystem more diverse and collaborative; helping individual citizens to invest in a sustainable economy; encouraging financial firms to develop sustainable business models; and creating the disclosures needed to manage the sustainability of the financial system.

Collectively, these themes and recommendations reflect the thinking of some of the pioneering practitioners and leading thinkers on sustainable finance who contributed to this report - with a particular emphasis on the role of sustainable banking as a major driving force in a sustainable economy.

A summary of the proposals is as follows:

Realigning finance with society

Without a shared understanding of the purpose of finance - what it is really there for - there is little chance that the financial sector as a whole will be well aligned with society's needs.



Sustainability assessments for assets

Encourage lenders to assess the real economy, public interest and sustainability aspects of each new exposure. Such a test could be designed in such a way to assess compliance with, for example, the Sustainable Development Goals (SDGs), or national economic transition plans.



Banks to formulate their purpose

Industry bodies to support their members to find and formulate their purpose in open dialogue with the public at large, with a view to formulating a purpose for themselves that is consistent with the SDGs and the mission 2020 agenda.

Recalibrating regulatory instruments to encourage real stability

Following from the argument in the previous section that finance needs to be realigned with society's needs, there is a case for using financial regulation to ensure that the financial system takes account of its impacts and interdependencies with the economy, society and the environment. Measures might focus on capital requirements, liquidity rules, reporting requirements, guarantees, technical assistance, fiscal measures and levies.



Capital requirements with sustainability weightings

Recalibrate capital measures for banks to address systemic risks by introducing capital support factors for sustainable and public-interest assets which demonstrate compliance or progress towards the Sustainable Development Goals; and additional capital surcharges for assets with higher environmental and social risks and which do not comply with the Sustainable Development Goals.



Guarantees, subsidies and technical assistance

Introduce support mechanisms including public authority or EIB guarantees, fiscal measures (tax incentives for either savers/investors or institutions), and technical assistance grants in order to stimulate investment in emerging sectors within the sustainable economy which still carry the risks of an immature market.



Sustainability levy for financial assets

Create a levy mechanism to penalise or reward financial institutions for the sustainability outcomes (such as climate risk) of specific assets as an alternative to using capital weightings. Levies on unsustainable assets could fund market support for sustainable assets in a revenue neutral way.

A diverse financial ecosystem to grow a sustainable economy

A more diverse financial industry structure – in which financial institutions have different business models, investment horizons and risk appetites – is needed to meet the targets for the Paris Climate Agreement and Sustainable Development Goals. This means breaking down banking monocultures to foster a more diverse ecosystem of sustainable finance partners, and helping the financial community to get involved in projects at an earlier stage.



Increased financial sector diversity

Create a toolkit for European cities, regions and public authorities on how best to convene a diverse ecosystem of sustainable finance partners – including impact investors, public banks, commercial banks, values-based banks, philanthropic research/innovation funders, local banks/credit unions, cooperatives and crowdfunding platforms together with mainstream finance and public finance institutions – to avoid the sector being dominated by one business model.



A European hub for sustainable investments

Create 'Sustainable Infrastructure Europe' as a centre of expertise and catalyst, where a diverse ecosystem of sustainable finance partners can co-develop projects, develop best practices and methodologies, share information about funding, and provide connections between similar projects.

Sustainable finance for all

Most people want to invest in a sustainable future. But when it comes to the choices available to individuals in Europe, the most direct and impactful investments are rendered inaccessible by regulation in almost all Member States. Some national initiatives to promote sustainable retail investing have worked well and could be replicated at EU level.



European Sustainability Funds for citizen investors

Create a new EU regulatory regime for sustainable investment funds available to ordinary citizens – opening these up for impact investment into long-term assets, based on expanding and generalizing some tried and tested models. A “UCISS” regime (Undertakings for Collective Investments in Sustainable Securities) could build on the success of UCITS (for transferable securities).

Sustainability – the reason why finance should make money

Being a leader in sustainability and an effective partner in new sustainable developments could be a major opportunity for value creation within the financial industry. This will need new competencies and channels of accountability at every level of the organisation, and transparency about the sustainability of financial firms' activities.



Sustainability training for finance workers

European Banking Federation to work with national banking associations to promote sustainable leadership and to encourage the uptake of accredited sustainability training and competency programs in all financial institutions.

Managing what matters most

To make real progress towards sustainability means ensuring that there is genuine focus on the long-term social, environmental and economic issues that matter, and being genuinely transparent about progress.



Reporting on sustainability

Add sustainability metrics to financial institutions' reporting, building on the French Article 173 approach to carbon emissions reporting, so that firms report on the proportion of the balance sheet that is SDG-compliant or not, alongside standard metrics such as profit and growth.



Loyalty Shares

Adopt a common recognition of 'L-shares', in which investors acquire additional benefits after holding a share for a number of years, across the EU, potentially with harmonised incentives, to tilt the balance towards loyal, long-term investors and enable companies to remain more focused on the long-term issues that matter most.



Realigning finance with society

What is finance for?

The financial crisis left many people feeling that finance had been allowed to develop with little sense of purpose beyond its own profitability. Financial regulation does not require financial firms to fulfil a social purpose, and until recently there had been little discussion since the crisis about what that social purpose might be.

Recent attempts to define the purposes of finance describe it in terms of activities, such as safe-keeping of assets, facilitating payments, mitigating risk and uncertainty, and intermediation (meaning credit creation and capital allocation).¹ A recent definition of sustainable finance describes the purpose as “to serve the economy and wider society...to underpin balanced prosperity and competitiveness, as well as to promote innovation that generates social inclusion, respects the environment, protects the climate and delivers on objectives for human rights”.²

Financial regulation does not focus on these goals. The legal obligations of finance usually consist of secondary, enabling, objectives such as maintaining financial stability, transparent market operations, treating customers fairly, and so on. The financial sector’s primary social responsibilities – to enable resources to flow to good ideas, or to help manage the relationships between the economy, people and the environment – are taken as read, or at best left for each financial institution to consider for itself. Some financial firms are transparent and conscientious about developing a bottom up, sustainable idea of their purpose, but they are probably in the minority.

Without a shared understanding of the purpose of finance – what it is really there for – there is little chance that the financial sector as a whole will be well aligned with society’s needs. Arguments for goals such as financial stability would remain circular: we must keep finance going in order to keep finance going!

This encourages a dangerously narrow view, in which a ‘neutral’ financial sector operates independently from the real economy, society, and the environment. As the financial crisis showed, the financial sector is built upon the real economy, and when it becomes detached then it risks bringing down the economy. Post-crisis regulation has tried to address this by tackling insufficient capital and inappropriate incentives, among other things. But the interdependencies

go further: the real economy is itself dependent on society and the environment. Unless finance can be repositioned within the relationships between economy, society and the environment instead of above and separate from them, future imbalances and instability are assured.

It is a common sense notion that if we damage our environment (for example by letting climate change occur), undermining cohesion in society or stalling our economies, then we can only logically expect financial instability. What is more, such instability could not be averted using the current set of tools: a financial crisis of this nature would be on an altogether different scale to what we have witnessed to date.

Until and unless we recognise the integrated and holistic purpose of finance, then we cannot realistically hope to create lasting financial stability. This fundamental paradigm shift in the underlying philosophy of financial sector leadership and regulation is required if we are to create a socially useful finance sector and a resilient future.

The good news is that this more interconnected view of finance is already being recognised by those who make financial policy, most notably in terms of climate change:

As the single biggest negative externality of modern times, Climate Change entails considerable risks. We need to act now given the implications for financial stability and future generations.

Luiz Awazu Pereira da Silva, Deputy General Manager, Bank for International Settlements (BIS)³

There is growing recognition of the role of participants within the financial system, including central banks and financial regulators, to mitigate financial risks from climate-related factors.

Bank of England, Quarterly Bulletin, 2017, Q2

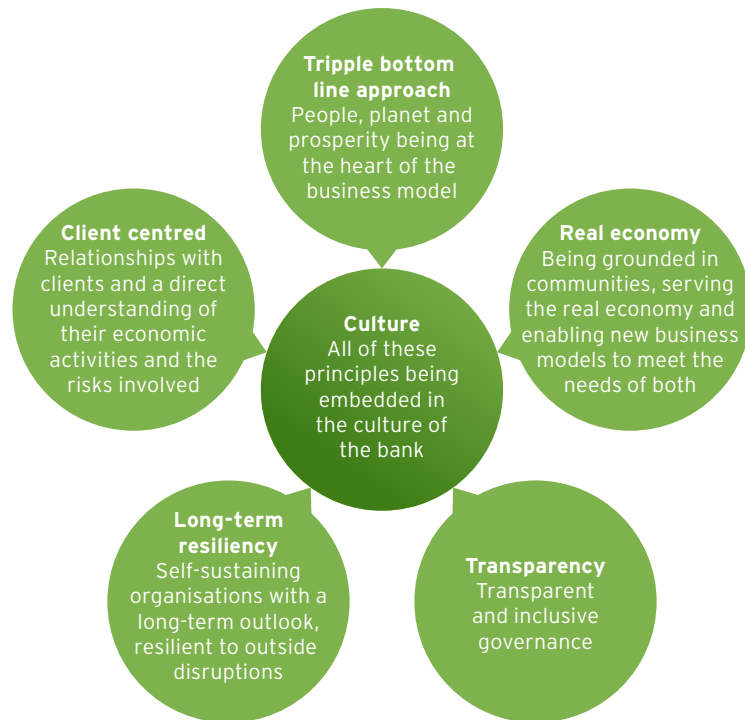
The consequences of this paradigm shift mean that banks and investors should carry a core responsibility to understand the real economy, public interest and environmental sustainability aspects of all loans and investments. It would require a step-change in sustainability competencies among everyone working in the financial sector. And it would mean a recalibration of the regulatory instruments currently employed to influence financial institutions' behaviours.

These concepts are expanded upon further within this paper.

Values-based-banking

Values-based banking already incorporates an understanding of its links with the real economy, society and the environment.⁴ Values-based banking always starts by looking at the social and environmental purpose and mission of an enterprise, putting sustainability at the heart of the bank's decision-making process. This ensures that banks stay focused on sustainability – but it can also have the effect of creating a deeper understanding of the context of underlying credit and the relationships of the stakeholders connected to a venture. Since there is more to a business loan than profit, there are more options to work with during difficult times. As a consequence, European values-based banks have demonstrated their resilience throughout the financial crisis and beyond and, most importantly, they have a concentration of lending to the real economy on their balance sheets that outstrips that of the largest banks in Europe by more than half.⁵

The five pillars of sustainable banking:



Source: Global Alliance for Banking on Values

If policymakers want to nudge more banks towards taking this approach, the first step would be to find ways of encouraging lenders to conduct an analysis of the social and environmental impacts of each exposure to ensure it is sustainable within its context.

Another measure that could help would be if industry bodies supported their members to find and formulate their purpose in open dialogue, not only with their clients but also with the public at large. Formulating a purpose in an open dialogue with the public would likely result in a purpose that is consistent with the SDGs and the Mission 2020 agenda.



Sustainability assessments for assets

Encourage lenders to assess the real economy, public interest and sustainability aspects of each new exposure. Such a test could be designed in such a way to assess compliance with, for example, the Sustainable Development Goals, or national economic transition plans. Initially, this could be encouraged as a voluntary disclosure, e.g. stating the percentage of compliance across a portfolio; later there could be a commitment to a transition (to 100%) within an ambitious/feasible timescale (say, five years to 2022); and finally, this could be followed up by prudential regulation that confers meaningful incentives and penalties on the basis of those disclosures.



Banks to formulate their purpose

Industry bodies to support their members to find and formulate their purpose in open dialogue with the public at large, with a view to formulating a purpose for themselves that is consistent with the SDGs and the Paris Climate agreement.

Endnotes

- 1 See Pitt-Watson D. and Mann H., The Purpose of Finance Why Finance Matters: Building an industry that serves its customers and society, Pension Insurance Corporation, March 2017
- 2 High-Level Expert Group on Sustainable Finance, Interim Report, Financing a Sustainable European Economy, July 2017
- 3 Speech, Green finance: can it help combat climate change? BIS, 13 July 2017
- 4 More than 40 banks around the world practise values-based banking as members of the Global Alliance for Banking on Values (www.gabv.org)
- 5 A comparison between a group of values-based banks and a group of Europe's largest banks found that 75.9% of the balance sheets of the values-based banks in 2015 were loans to the real economy, versus only 47.6% for the large banks. In addition, the values-based banks were less leveraged than the large banks (8.6% equity/assets versus 6.1%) and had higher return on assets (0.35% versus 0.21%). The return on equity of the two groups was similar (4.0% versus 4.2%) but the values-based banks' return on equity was far less volatile (1.5% standard deviation versus 4.6%). Source: GABV, Real Economy - Real Returns: The Power of Sustainability-focused Banking, 2015



Recalibrating regulatory instruments to encourage real stability

What regulatory instruments are needed for sustainable financial stability?

The following discussion distinguishes between the sustainability of the financial system itself – including whether banks have enough capital to survive a future crisis – and the impact of finance on environmental, social and economic sustainability – including how capital rules differentiate between sustainable and unsustainable assets, as well as fiscal policy and levies.

Following from the argument in the previous section that finance needs to be realigned with society's needs, there is a case for using financial regulation to ensure that the financial system takes account of its impacts and interdependencies with the economy, society and the environment. Indeed, such measures are central to achieving a resilient and stable financial sector, as regulators are increasingly aware.

This means exploring a range of instruments and measures (both incentives and penalties):

- Simplifying regulation for small, simple and sustainable institutions to promote diversity in the financial sector – for example limiting the requirements on reporting, disclosure, remuneration and committee structures that are placed upon large, complex, systemic banks.
- Re-weighting capital requirements based on sustainability criteria – e.g. green support factors and brown 'add-ons'.
- Liquidity rules – ensuring they don't create a disincentive to invest in the long term.

- Fiscal rules – tax incentives for savers and investors; ending tax relief for debt (leveraging balance sheets).
- Introducing a levy mechanism in the financial system so that market ‘externalities’ are priced in.

Where to start? The banking sector

Banks finance the majority of Europe’s economy, including the businesses and households that need to make the sustainability transition if we are to meet the goals of the Paris Climate Agreement, Sustainable Development Goals and more. They also finance around 80% of green infrastructure in Europe,⁶ and the capital rules governing banks in Europe are under review during 2017.⁷

For the banking industry as a whole, capital requirements are a core driver for market behaviour, with knock-on consequences for the real economy.⁸

So total capital levels matter, and avoiding high leverage is a prerequisite for the financial system’s own sustainability. Making banks better capitalized than they are now would make them less prone to bankruptcy and therefore able to take on more long-term risks and commitments. Conversely, any use of capital regulation to promote wider sustainability goals should not undermine the levels of capital currently available in the financial system to absorb losses.

We can design changes into the current review of capital requirements regulation.

Beyond the overall level of capital is the question of capital allocation, and to what extent capital requirements can be adjusted to encourage “green” and penalise “brown” assets. As commented in the interim report from the High Level Expert Group on Sustainable Finance:

As the largest asset pool, banks have an essential role in the transition towards a sustainable financial system. To date, however, their potential contribution to sustainable development has not reached its full potential. Green “support factors” or brown “add-ons” could be investigated; the appropriateness of the capital framework for project finance and specialised lending should be assessed; while Pillars II and III of prudential regulation could be strengthened with regard to sustainability.

Capital regulation already includes credit, market and operation risks. Adding sustainability risks would be a new departure but one that is fully justified, as the stranded asset debate shows.⁹ For banks to genuinely reflect their systemic risks within capital calculations then banking regulators should be re-weighting capital for different assets based on a blend of risk factors and sustainability criteria, taking into account not only the impact on the bank, but on the global economy as well. Risk weights could be adapted to reflect systemic economic, social and environmental risks, in a way that targets the distribution of capital between assets rather than the overall level of capital. The EU’s Capital Requirements Regulation (CRR) itself recognises (Recital 122) that: *The primary purpose of the legal framework for credit institutions should be to ensure the operation of vital services to the real economy while limiting the risk of moral hazard.*

Capital for Systemic Risk

For example, imagine a bank with an exposure to a company operating with unsustainable land and water management practices in an area at higher risk of drought or land degradation. Whilst the capital calculations for the loan should take into account the potential risk of financial loss to the bank (this is not yet fully embedded in prudential rules) if financial stability is to be maintained overall, there should be an additional measure to cover the potential loss to other future economic activity as a consequence of the damage to the environment and local community. Equally there can be positive measures which can incentivise sustainable and restorative investments which benefit or repair the local environment. This concept can be integrated into capital weightings – both support factors and surcharges through amendments to the European Capital Requirements Regulation (CRR). However beyond prudential arguments that only classify credit risk for an asset, we could use a simple multiplier based upon the degree of (non-)compliance, or progress being made to the Sustainable Development Goals under a public-interest test.

As long as bank capital requirements remain a function of risk, then banks that are exposed to unsustainable assets must accept to post additional capital for those assets commensurate with the additional system risk their underlying activity presents, both to them individually and to the financial system as a whole. In return, there should be capital support factors (discounts) applied to sustainable activity which is in line with the priorities of society. Creating a gap between the capital costs of sustainable versus unsustainable assets would have a positive impact on credit allocation.

As things stand, risk weights influence credit allocation, even if that is not what regulators intend. When the concept of risk weighting different assets on bank balance sheets was introduced with the first Basel accord in 1988, residential mortgages carried half the risk weight of loans to companies. A significant share of the global growth in mortgage lending occurred in the years after that.¹⁰ As the European Banking Federation explains, *banks' lending business is driven by margins. Therefore any capital relief has a direct business-boosting impact*, as one of a mix of factors affecting individual lending decisions.¹¹

The idea of using risk weights deliberately to influence credit allocation already exists in EU policy in the Capital Requirements Regulation. This introduced a support factor for lending to small and medium sized enterprises (SMEs) in 2014, a time when banks might otherwise have cut their SME lending as they were transitioning to higher capital levels after the crisis. SMEs are of vital importance for the EU's real economy in terms of their share of employment creation and value added.

The question of how large any green supporting factors or brown surcharges would need to be to make an impact, and how long it would take for them to take effect, would need to be considered carefully, taking into account the experience with the SME supporting factor.¹²

The SME supporting factor is not the only current example of regulatory credit guidance. We are seeing similar interventions from central banks in specific parts of the economy:

The Bank of England's Funding for Lending 2 Scheme (FLS) has incentives deliberately skewed to boost SME lending but not mortgage lending. The ECB's new long-term repo facility, introduced in September 2014, is similarly skewed; so too was the lending package introduced by the Bank of Korea in June 2014. And during 2014 the PBOC, seeking to support growth but without further exacerbating the credit and property boom, made reductions in the required reserve asset ratio which are targeted on agriculture and particular categories of business.

Adair Turner (INET, Shanghai 2015)



Capital requirements with sustainability weightings

Recalibrate capital measures for banks to address systemic risks by introducing capital support factors for sustainable and public-interest assets which demonstrate compliance or progress towards the Sustainable Development Goals; and additional capital surcharges for assets with higher environmental and social risks and which do not comply with the Sustainable Development Goals. This should be supported by ESG considerations in pillar 2 (new CRD article 87a and new letter (k) in CRD art 98) and confirmed with disclosure requirements in CRR part eight.

In a future regulatory regime that was mandated to support a holistic approach to financial stability, a blend of measures could be applied in relation to the specific local, sectoral and commercial context including capital measures (support factors/surcharges), fiscal rules (tax relief applied via Member States), and guarantees/technical assistance (via Member States or EIB facilities).



Guarantees, subsidies and technical assistance

Introduce support mechanisms including public-authority or EIB guarantees, fiscal measures (tax incentives for either savers/investors or institutions), and technical assistance grants in order to stimulate investment in emerging sectors within the sustainable economy which still carry the risks of an immature market.

In addition to this palette of instruments, a further mechanism to incentivise sustainability could be introduced by the financial sector where primary markets are slow to reprice externalities (for example until such time that there is a definitive price for carbon emissions). Such a mechanism could be set up as a levy on unsustainable bank assets and used to fund support mechanisms for more sustainable bank assets (for example putting a price on high carbon loans and investments and redistributing the penalties amongst those in the sector who are financing low carbon loans and investments, similar to the use of tradeable certificate schemes in energy markets).

This would have the advantage of being revenue-neutral for the sector as a whole, whilst accelerating the preference for sustainable assets. In particular, from a behavioural perspective, financial institutions may be motivated by avoiding a loss (in the form of a penalty). This could be particularly useful in accelerating the transition away from high climate risks assets within a timescale relevant to the time horizon necessary to combat climate change effectively.¹³ Such a mechanism would also add relevance to disclosure rules such as those recommended by the Taskforce for Climate-related Financial Disclosures (TCFD) and efforts to account for carbon on bank balance sheets such as the Platform for Carbon Accounting Financials (PCAF).

Repricing negative externalities can have positive effects: since Sweden introduced a carbon price in 1990, **CO2 has reduced by 22%**, whilst **GDP has grown by 58%**.

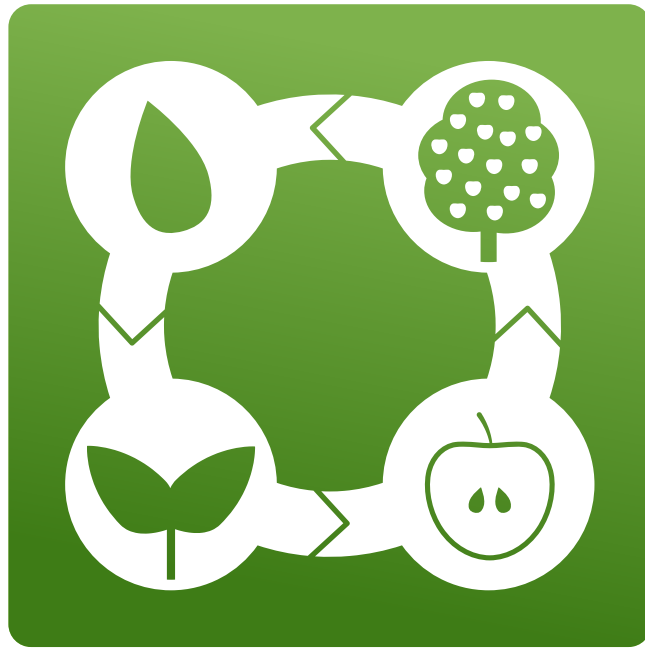


Sustainability levy for financial assets

Create a levy mechanism to penalise or reward financial institutions for the sustainability outcomes (such as climate risk) of specific assets as an alternative to using capital weightings. Levies on unsustainable assets could fund market support for sustainable assets in a revenue neutral way.

Endnotes

- 6 UNEP Inquiry, Greening the Banking System: Taking Stock of G20 Green Banking Market Practice, Inquiry Working Paper 16/12, September 2016 (1.1)
- 7 <https://ec.europa.eu/info/node/6089>
- 8 Higher overall levels of capital lead to higher real economy bank lending. Studies find an optimal level of regulatory capital somewhere between 15 and 20% of total assets, once banks have transitioned to the higher level.
 - Bank of England, The impact of capital requirements on bank lending, Working Paper No. 486, January 2014
 - Admati et al, Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Socially Expensive, Working Paper No. 2065, October 2013
 - Deutsche Bundesbank, Does capital regulation matter for bank behaviour? Evidence for German savings banks, Discussion Paper Series 2 No 03/2004, 2004
- 9 For example, the combined market capitalisation of the top four US coal producers fell by over 99% since the end of 2010, and three have filed for bankruptcy. See speech by Mark Carney, Resolving the climate paradox, September 2016
- 10 The Great Mortgaging: Housing Finance, Crises, and Business Cycles, Jordá O., Schularick M., Taylor A., Federal Reserve Bank of San Francisco, September 2014
- 11 EBF Draft Response to the EBA Discussion Paper on the SME Supporting Factor, 1 October 2015
- 12 The European Commission has decided to continue the SME supporting factor as part of its 2017 review of bank capital regulation. A 2016 study concluded it was too soon to see a stimulus effect as banks were still rebuilding their capital after the crisis. The study did not examine whether SME lending would have fallen without the supporting factor. European Banking Authority, EBA/OP/2016/04, 23 March 2016
- 13 For guidelines on the level of carbon price that would permit the Paris Agreement targets to be achieved, see the recent Stern Stiglitz report on carbon prices, Report of the High-Level Commission on Carbon Prices, World Bank, May 2017



A diverse financial ecosystem to grow a sustainable economy

A lack of diversity is holding back sustainable finance

How do we break the paradox of there being too few sustainable projects in the eyes of the financial sector, and not enough finance for sustainable projects? What often happens is that the financial sector is treated as one single, monolithic entity with one set of norms, values, risk appetites and specialisms. And with insufficient diversity in the financial system, this too often turns out to be the case. Promising projects are often developed within stakeholder groups that do not include finance until they are ready to be presented.

For the necessary diversity of sustainable projects to be financed across Europe – in particular those which are innovative and unfamiliar – a broad spectrum of financial partners, sector specialisms, risk appetites and techniques are required. This means having a diverse ecosystem of sustainable finance partners – including impact investors, public banks, commercial banks, values-based banks, philanthropic research/innovation funders, local banks/credit unions, cooperatives and crowdfunding platforms convened together with mainstream finance players by cities, municipalities and other regional or national public authorities – without any one group or business model dominating.

The answer lies partly in using regulation to break down banking monocultures, as in the EU where the sector is dominated by too-big-to-fail banks, and promoting banks with a variety of business models, for example banks with a sustainable focus, mutuals and cooperatives, and smaller local banks that focus on SME lending. It also lies in changing the relationships between

project developers, public authorities, cities and regions and the financial community. By creating platforms for financial partners to be included in shaping and co-creating solutions, there could be a breakthrough in the volume and scalability of sustainable investments across Europe.

Examples of collaborative platforms at a city level are already emerging – for example the Integrated and Replicable Solutions for co-creation in Sustainable Cities (IRIS) projects in Utrecht, Nice and Gothenburg where financial institutions can get involved directly in taking a role in a local entrepreneurial ecosystem to promote innovation and local development towards smart, sustainable cities. And the financial community is also starting to explore how it can form more collaborative hubs for solution-building as currently being designed as part of UNEP-FI's Positive Impact Finance program.¹⁴



Increased financial sector diversity

Create a toolkit for European cities, regions and public authorities on how best to convene a diverse ecosystem of sustainable finance partners – including impact investors, public banks, commercial banks, values-based banks, philanthropic research/innovation funders, local banks/credit unions, cooperatives and crowdfunding platforms together with mainstream finance and public finance institutions – to avoid the sector being dominated by one business model.

When there is sufficiently diverse a group of collaborating financial partners, there is greater chance not only of achieving more systemic resilience but also of making faster progress towards sustainability goals and achieving successful funding outcomes.

Crowding-in the mainstream

Mainstream finance is often wary of the risks of investing in innovative projects. But once an innovative project has become more familiar and commonplace, mainstream financial institutions are more likely to get involved. They may even invest heavily once the activity becomes commoditised (as seen in renewable energy generation investments). Public investment in early stage, innovative projects could therefore set the scene for mainstream financing at a later stage.

The role of public finance

There are many sources of public finance across the EU, but these must be used optimally in order to stimulate and crowd in private sector funding.¹⁵ Pressures on public money that followed the financial crisis have slowed down the tendering of public projects, including projects for sustainability (such as decarbonization of transport in Europe). There is also underinvestment in research and development and early stage green technologies. By understanding the lifecycle of investment themes and technologies, it should be possible to stimulate early investment in innovative projects, offering instruments such as guarantees and first-loss provisions, in order to build familiarity with values-based financial partners who are willing to invest the time. Once investment is flowing, support can be gradually reduced over time until the sector matures and investment is no longer required (and can therefore be redeployed to stimulate further innovation and improvement).

This will require some institutional oversight. In its interim report in July 2017, the European Commission's High Level Expert Group on Sustainable Finance proposed the creation of a new body, 'Sustainable Infrastructure Europe', to help public authorities access private funding for sustainable infrastructure plans. As part of its mandate, the body should encourage a diversity of public and private funding providers and ensure that projects come with an appropriate level of market support to successfully crowd in the private financial sector. 'Sustainable Infrastructure Europe' could also contribute to creating a diverse ecosystem of sustainable finance partners so that organisations, cities, regions and public authorities can co-create solutions together with a variety of the funders. The body could accelerate progress via offering

advisory services, sharing best-practice guidelines, signposting available funding support and providing connections between similar project developments in order to share experience and learning. Acting in its role as a centre of excellence, it could create new methodologies and tools to help banks and cities assess the true costs of projects. We believe that many of the new institutions in the EU - including the European Fund for Strategic Investment (EFSI), the national development banks at member state level, and other pillars of the Investment Plan for Europe - could be specifically developed with the idea of promoting financial diversity in mind.



A European hub for sustainable investments

Create 'Sustainable Infrastructure Europe' as a centre of expertise and catalyst, where a diverse ecosystem of sustainable finance partners can co-develop projects, develop best practices and methodologies, share information about funding, and provide connections between similar projects.

The role of values-based finance

Within the diverse ecosystem of financial partners required to successfully co-create sustainable solutions are values-based finance providers. Values-based banks, such as the members of the GABV have been active across Europe, pioneering lending to sustainability sectors.

They are leaders in sustainable mortgage products encouraging household energy savings, and are leaders in renewable energy infrastructure lending.¹⁶ Values-based banks across Europe have been involved in developing innovative finance solutions for financing the environmental and social economy - for example in energy efficiency finance and social impact bonds. And many of these institutions leverage the sustainability practices across their stakeholder community for the benefit of all their customers.

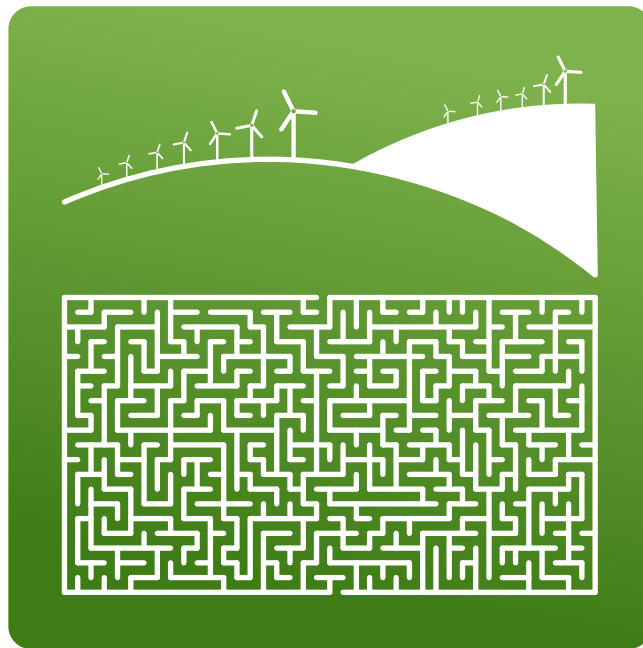
Using this diversity of experience, values-based banks are able to act as effective speaking partners for businesses and developers across the sustainability sectors that they cover. And it is not just within a sector: some of the most useful connections that can be made by values-based banks are *between* sectors. For example, sharing experiences between energy efficiency developers and health/social care providers or cultural venues in how to improve the environmental performance of specialised buildings; or introducing organic food businesses to sustainable leisure and tourism destinations. This interweaving of sustainability practices within a network of pioneering and mission-led organisations has the potential to catalyse real innovation and lead to the acceleration of sustainability within the broader economy.

Project example: Nord-Pas-de-Calais

Nord-Pas-de-Calais is a real case showing how to usefully combine ESI Funds and EFSI support, in particular as it enabled maximising the private sector participation. The project aims to develop a low-carbon economy in the region (Third Industrial Revolution - TRI) and intends to make the Region a "zero- emissions" energy model by 2050, while at the same time creating employment, developing the overall economy and combating fuel poverty. To this end, a "layered" fund was set up which invests risk capital in enterprises developing TRI projects: the Region will participate, using ESI Funds, providing equity financing alongside public and private investors. The EIB, supported by the EFSI, will provide mezzanine debt to the fund and commercial banks will provide senior debt at project level. In addition to financing, the Region also covers technical assistance thanks to a grant of up to EUR 2.5 million drawn from ESI Funds resources.

Endnotes

- 14 Positive Impact Manifesto, UNEP-FI, Positive Impact Finance: A Common Vision for the Financing of the Sustainable Development Goals, June 2017
- 15 See the infographic from the Covenant of Mayors, Quick Reference Guide - Financing Opportunities for Local Climate & Energy Actions (2014-2020)
- 16 According to Clean Energy Pipeline, in 2016, Triodos Bank arranged new project finance loans of €500m for 70 renewable energy projects - more facilities than any other bank in Europe.



Sustainable finance for all

A sustainable finance sector that serves society needs to include citizens.

So why is it so hard for retail investors to put their money into sustainable investments?

According to a recent study, 84% of millennials (people born between 1980 and 2000) cite investing with a focus on environment, social and governance (ESG) impact as a central goal.¹⁷ And it is not just the millennial generation who are concerned about our collective future; most people want to invest in a sustainable future.¹⁸ But when it comes to the choices available to individuals in Europe, the most direct and impactful investments are rendered inaccessible by regulation in almost all Member States.

That means that individual citizens who are keen to invest in a sustainable future by way of participating in positive impact investment are being blocked by rules that prevent them. The popularity of crowdfunding among retail investors reveals the demand for engaged investments.

Much of the regulation being applied here has the right intentions: to protect individuals from risks that they don't understand. The protection typically follows the following principles:

- Liquidity - individuals can only invest into funds where there is underlying liquidity, i.e. they can change value for cash if they need to.
- Regulated fund managers and distributors - individuals can only be serviced by fund managers and distributors that adhere to basic rules of care, transparency and integrity, and ensure that people are buying instruments that suit them.
- Diversification - individuals cannot be expected to bear the consequences of price volatility of concentrated underlying assets.

These principles, as much as they are valid for investor protection, should however not translate into a limitation of investing only in "transferable", i.e. listed securities. This translation reveals a faith in market liquidity that proved unjustified during the crisis when supposedly liquid markets dried up, and undermines economic development by turning investors into traders.

Regulators could protect retail investors in other ways, for example by ensuring that investment products are suitable for retail investors' needs or by requiring investment funds to control inflows and outflows of cash in a sound manner, without limiting their ability to invest in sustainable projects.

From a systemic risk perspective, it can also be argued that the more people become aware, educated and experienced, the systemic risk will reduce:

Encouraging citizens to become impact investors, even at very modest levels, gives the opportunity for people to become reconnected - not just to their money, but also to the social and environmental impacts that this has. It builds a more resilient, better informed, investor culture that it is more practiced and aware of making investment decisions and understanding investment risks. Resilience among a distributed and diverse population of investors could help to enable a less fragile and more stable financial system - creating benefits for the whole of society.

Impact Investing for Everyone; Paper for the G8 Social Impact Investment Taskforce (2014)

Current legislation restricts impact funds such as the European Social Entrepreneurship Fund structure created in 2014, to individuals with a minimum investment of EUR 50,000 (originally EUR 100,000). It is little wonder why the review of the scheme reported that: *the EUSEF results have been disappointing.*



European Sustainability Funds for citizen investors

Create a new EU regulatory regime for sustainable investment funds available to ordinary citizens - opening these up for impact investment into long term assets, based on expanding and generalizing some tried and tested models. A "UCISS" regime (Undertakings for Collective Investments in Sustainable Securities) could build on the success of UCITS (for transferable securities).

By 2020 this could lead to millions of new investors across the EU in a sustainable economy, engaging with the sustainability transitions around them, changing the culture of finance and driving demand for new sustainable financial products and services.



Where direct retail impact funds have been created, there have generally been positive experiences:

Energy Cooperatives

Amongst the registered cooperatives across Europe (more than 160,000, with over 123 million members) are 2,397 energy co-operatives. Within Germany, Denmark and Austria combined there are 1,240 cooperatives with 650,000 citizens active in the energy transition.¹⁹

Netherlands: Green Funds ²⁰

In the Netherlands, the Green Funds allow individuals to invest in funds, managed by banks, specifically directed at qualifying green projects such as renewable energy, wildlife conservation, and organic farmland. At least 70% of the funds' volume has to be invested in qualifying green projects. Between 2000 and 2009, there were 6,066 projects financed with over €7.3bn of funding from quarter of a million individual investors:

Category	Number	Percentage
Nature, forests and landscape	792	13.06%
Organic farming	1608	26.51%
Green label greenhouses	1680	27.70%
Agrification	6	0.10%
Renewable energy	1184	19.52%
Sustainable construction	546	9.00%
Voluntary soil sanitation	2	0.03%
Cycle-track infrastructure	1	0.02%
Other projects	247	4.07%

UK: Venture Capital Trusts and Direct Retail Investments

In recent years, Venture Capital Trusts have been major investors in low-carbon technology and other sustainable investments. The median investment is less than GBP 20,000.²¹

Beyond sustainable listed equities held in funds, the UK has a growing market for direct retail investments – share and bond issues with individual subscribers at modest levels. Recent legislation has provided incentives – for example a Social Investment Tax Relief²² for individual investors.

France: Solidarity Funds

Assets in solidarity investment funds are now over **€6 billion**. This has led to over 1 million individual savers in France.²³

Solidarity investment funds are invested up to 10% in social investments into 'solidarity designated' organisations and 90% or more in listed securities (both equities and fixed income), which are managed according to core Social Responsible Investment (SRI) principles. The social issues that have benefited from investment include the environment (37%), housing (31%), employment (22%), and international solidarity (development) (5%). This data describes the broader solidarity finance market in France, not just solidarity investment funds, but it is believed to be reflective of the split amongst investment in the 5-10% of the high impact segment of the solidarity investment funds. Similar schemes to the 90:10 model are being proposed by organisations such as Big Society Capital in the UK.²⁴

Sustainable Finance needs to become an inclusive agenda where citizens are the co-creators, not the passive subjects of a future economy. This means supporting and enabling more individual citizens to participate in positive impact through sustainable impact investing and saving products.

Endnotes

- 17 Ernst & Young, Sustainable investing: the millennial investor, 2017
- 18 Bloomberg, Millennials Are Coming and They Want Sustainable Investments, 26 October 2016
- 19 <https://rescoop.eu/facts-figures-0>
- 20 The Green Funds Scheme: a success story in the making: https://www.rvo.nl/sites/default/files/bijlagen/SEN040%20DOW%20A4%20Greenfunds_tcm24-119449.pdf
- 21 <https://www.gov.uk/government/collections/venture-capital-trusts-statistics>
- 22 <https://www.gov.uk/government/collections/social-investment-tax-relief>
- 23 www.finansol.org/_dwl/social-finance.pdf
- 24 Big Society Capital, Designing a Social Investment Fund for UK Pensions, A Technical Paper, October 2016



Sustainability: the reason why finance should make money

Putting sustainability at the core of the finance sector

There is a risk of sustainability being *bolted on* to existing business models which are too narrowly focused on maximizing financial outcomes, rather than being *built in* to new business models that take a holistic view. To enable sustainability to be genuinely built-in to the core requires a new culture and set of skills from the people working in the finance sector at every level of the organisation – all the way to up the CEO and board.

The new culture of sustainable finance professionals

Given the importance of core roles of finance such as understanding risk or combatting financial crime, there is a ‘training and competency’ regime ensuring that everyone within the organisation is fully aware of their responsibilities and knows how to act. Likewise then, if we really want sustainability to be in the core of finance, then first we should address the fact that there is no training and competence regime for sustainability within financial institutions. A sustainable finance sector needs sustainable bankers and sustainable investors, fully conversant and competent in managing sustainability issues.

Of course, training people does not guarantee that sustainability will become a core value, only that people will be familiar with it, or proficient at making sustainability decisions. Some level of accountability is needed to consolidate the benefits. This could include, for example, linking any regulatory reliefs or other benefits that the financial institutional enjoys to whether its staff carry out sustainability assessments and reporting properly.

But this should not be seen as another compliance challenge. Integrating sustainability can become a leadership driver that stimulates a “race to the top” between financial institutions. In a world where finance is being disrupted by rapid technological commoditisation, the sector must look for new ways to create value. In an economy where businesses and individuals are trying to solve sustainability challenges – such as reducing energy consumption, creating sustainable employment, and investing in

low carbon infrastructure, being a leader in sustainability and an effective partner in new sustainable developments could be a major opportunity for value creation within the financial industry.

There are several organisations already providing education in sustainability for finance: the Institute for Social Banking runs summer school programs for finance professionals; the Cambridge Institute for Sustainable Leadership runs programs for sustainable finance; the Chartered Institute of Bankers is collaborating with the Finance Innovation Lab to create a training module on Green Finance; and MIT have created an online course together with the GABV on sustainable banking.

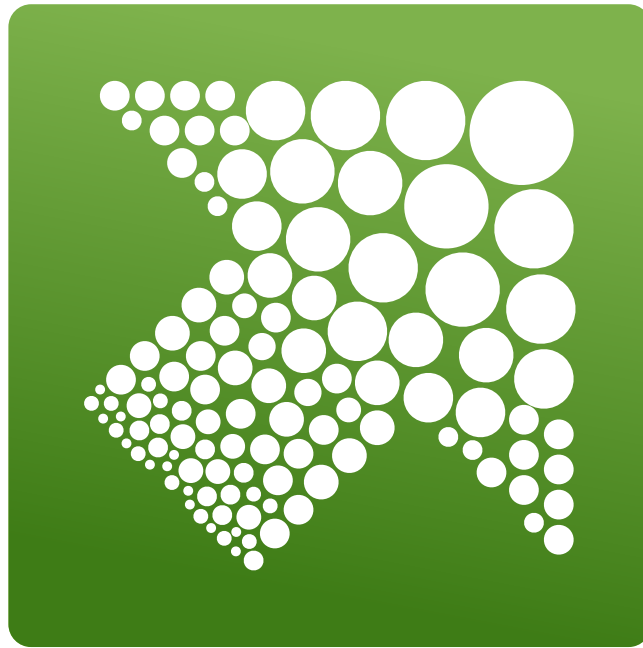
However, beyond education, the practice of sustainability should be reinforced through every credit decision and client interaction. The experience of values based banks has been that by creating space for attention and reflection, sustainability becomes naturally built in to the culture of the organisation.



Sustainability training for finance workers

European Banking Federation to work with national banking associations to promote sustainable leadership and to encourage the uptake of accredited sustainability training and competency programs in all financial institutions.

The Bankers' Oath (introduced into the Netherlands in 2015 to put the "customer's interest first") could be extended to a European-wide oath for the financial profession thinking about the responsibilities to a broader group of stakeholders - encouraging sustainability thinking in financial decisions and a commitment to deepening their awareness and practice of sustainability within their finance careers.



Managing what matters most

To manage what matters most means focusing on the core – recognising where the major impact falls from a financial institution’s loan or investment portfolios. Whilst greater transparency and disclosure is a very necessary step in helping financial institutions and stakeholders recognise the issues that need to be addressed, it will not be sufficient until the focus is clearly placed upon the areas of the business which make the most difference. Centrally for banks and investors, this is about the direction and allocation of their credit and investment – and the degree to which it contributes, positively or negatively, to key sustainability goals.

For Europe to address the major challenges of today’s world including the Paris Climate Agreement and Sustainable Development Goals, we need clarity and focus. We must be clear about the meaning and implications of terms within our taxonomy – to separate what is sustainable from what is unsustainable. But when seeking solutions to challenges where new approaches are required, we need to calibrate our understanding of sustainable beyond a simple classification of ‘green’ or ‘brown’, ‘social’ or ‘anti-social’; we have to recognise that there are activities which are compliant (that do no harm), make progress towards a positive goal (albeit with tried and tested means), and those which are pioneering or transformative and could accelerate our progress towards a positive goal. This calibration is essential in being able to make rational allocations of positive impact and balance them against choices of risk appetite. No one in the financial sector would make the binary classification of ‘risky’ or ‘not-risky’, so we need to develop more sophisticated language around the calibration of our impact.

Likewise, in approaching the potential funding gap to meet the objectives for the SDGs or Paris Climate Agreement, we should recognise that the gaps are not all alike. Some SDG investment gaps have proven solutions that just need to be deployed at scale, such as renewable energy, whereas other approaches require more development and co-creation within a diverse financial ecosystem.

This year’s [2017] report finds that while progress has been made over the past decade across all areas of development, the pace of progress has been insufficient and advancements have been uneven to fully meet the implementation of the SDGs (United Nations).²⁵

The most important factors to financial sector stakeholders relate to the core principles of sustainability – and these are the areas where there are the biggest gaps on performance.



Leadership effectively
represents interests
of all stakeholders

Importance 81/Performance 61

20



Develops innovations
with positive impact
on my life and world

Importance 82/Performance 63

19



Contributes
to the
greater good

Importance 83/Performance 61

22

Source: Edelman 2017 Trust Barometer - Financial Services

The right lens to view transparency

Radical openness means enabling people to see and understand how the financial system operates – so they feel engaged and included. It means managing what matters most and communicating that openly.

With this form of transparency, financial institutions can become more understood and act more effectively as partners in the economy. For example, Global Alliance for Banking on Values' 'Sustainable Banking Scorecard' measures quantitative factors (such as the percentage of banks' balance sheets allocated to real economy lending and to 'triple bottom line' lending), alongside qualitative factors (such as transparency and management systems). The UK Banking Futures report on long-term finance (2017) suggested reporting on bank culture via employee surveys.

Perhaps the best known example is Article 173 of the French Energy Transition Law, which makes it mandatory for French corporates, banks and other financial institutions to report their CO2 emissions, their financial exposure to climate change risk and their mitigation plans. This reporting should be extended to other countries and other measures of sustainability.

But real transparency does not mean proliferating reports and metrics, otherwise there is a risk that the real picture is 'obscured by over-disclosure'. The goal is to promote understanding and engagement so that institutions can show that they are responding to what matters to their stakeholders.



Reporting on sustainability

Add sustainability metrics to financial institutions' reporting, building on the French Article 173 approach to carbon emissions reporting, so that firms report on the proportion of the balance sheet that is SDG-compliant or not, alongside standard metrics such as profit and growth.

Aligning for the long term

In addition to this, capital markets have become increasingly short-term with practices such as high-frequency trading eroding the relationship between investor and company. A longstanding idea in practice in some European countries is to offer Loyalty Shares (L-Shares) with additional voting rights (and potentially other benefits) for shares which have been held for a longer period of time (generally 2-3 years, considerably longer than the average holding period).



Loyalty Shares

Adopt a common recognition of 'L-shares', in which investors acquire additional benefits after holding a share for a number of years, across the EU, potentially with harmonised incentives, to tilt the balance towards loyal, long term investors and enable companies to remain more focused on the long term issues that matter most.

25 United Nations press release on Sustainable Development Goals Report 2017

Next steps

The proposals presented within this paper are ambitious and potentially transformative. But they are also both feasible and necessary; with references grounded in many decades' experience by leading sustainable finance practitioners across Europe. They are offered beyond self interest, with a genuine intention to support the fundamental transition of the finance sector for the public good.

We hope that these ideas are useful input into the discussions within the High Level Expert Group on Sustainable Finance and other organisations discussing sustainable finance at European, national or global level. We invite stakeholders to develop these ideas further, incorporating or enhancing these proposals and continuing to make the financial system fairer, more inclusive and more sustainable.

If you have any direct comments or questions on this report please contact NewPathways@gabv.org

This report was produced with thanks to the following participants for their contributions:

Global Alliance for
Banking on Values

Finance Watch

Mission 2020

Triodos Bank

GLS Bank

Credit Cooperatif

Merkur Bank

Alternative Bank Schweiz

Cultura Sparen Bank

MagNet Bank

Ekobanken

Ecology Building Society

Banca Etica

Finance Innovation Lab

Share Action

SOMO

Positive Money

Partners for a New Economy

Sustainable Finance Lab

Climate Action Network

Global Impact

Investors Network

E3G

Linda van Goor

Sandrine Dixon-Declève

Dirk Schoenmaker

Editors

James Vaccaro, Triodos Bank

Greg Ford, Finance Watch

Jill Whittaker

Design

Eatcake Design, Bristol, UK