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SIMPOL Project

Highlights from DOLFINS Consortium's responses to the HLEG Sustainable Finance questionnaire

by SIMPOL | Sep 12, 2017 | Engagement - Sustainable Finance | 0 comments

The HLEG on Sustainable Finance has invited all citizens to provide feedback to their Interim report via a non-technical questionnaire by Sept. 20th. Early feedback received by Sept. 6th will contribute to next HLEG discussion on Sept. 11th.

In this post we publish the **highlights of the responses of the DOLFINS Consortium**. *The future of Europe depends on Sustainable Finance. Citizens have the unique opportunity to contribute to the debate at an early stage, well before the policy proposal is issued. The FET-funded project DOLFINS is supporting this effort. The contributions of DOLFINS members are published in a series of blog posts on the simpolproject platform and on our twitter profile Follow @simpolproject.*

Question 1. From your constituency's point of view, what is the most important issue that needs to be addressed to move towards sustainable finance? (sustainable finance being understood as improving the contribution of finance to long-term sustainable and inclusive growth, as well as strengthening financial stability by considering material environmental, social and governance factors).

Highlight:

Credibility and governance. In the last two decades, the financial system has largely decoupled from the real sector and many actors have engaged in excessive risk-taking and collective moral hazard. The cost of assisting the financial system in Europe has been massive (about 5% of GDP, according to the ECB). Therefore, it is crucial that sustainable finance develops as a credible set of instruments and players in order to avoid becoming the ground for engaging in green-washing and to prevent a potential green bubble.

Policy stability and coordination. We need a stable EU-wide green policy framework coordinated with the Investment Plan for Europe and the Circular Economy Agenda in order to promote demand for green projects.

A conceptual paradigm shift. Standard economic and finance theories alone cannot deliver a stable and sustainable financial system. They give too little attention to aspects that are essential to sustainable finance such as: complexity of the investment and lending chains, financial interconnectedness and contagion, moral hazard and building-up of instabilities, role of money and banks, distributional effects of policies and inequality.

Complementary approaches based on network models and stock-flow-consistent agent-based models are ready to deliver policy insights into sustainable finance. These approaches provide insights complementary to those from standard theories such as DSGE (Dynamic Stochastic General Equilibrium) and IAM (Integrated Assessment Models). Examples include metrics to assess climate risk and financial stability as well as dynamic models to assess the impact of fiscal and monetary policies.

Sustainable finance is much more about creating new markets than simply fixing market failures. In this respect the approach of mission-oriented innovation policies provide crucial insights on how to proceed.

Better data: a coordinated EU-wide program on sustainable finance data. Currently available data on firms, assets and lending/investment/ownership chains is often poor, scattered, not granular enough, costly or difficult to access even to policy makers. We need to develop an EU-wide data infrastructure for sustainable finance with regulated access in order to carry out frequent and independent valuation of institutions' portfolio risk and alignment with SDG (Sustainable Development Goals) objectives.

DOLFINS engages with key policy and sustainability stakeholders. The DOLFINS consortium has been working on these applications in collaboration with policy making bodies such as the ECB and Bank of England and is engaging in dialogues with key stakeholders in the sustainability arena such as the EIB, the World Bank, and the InterAmerican Development Bank.

Question 2. What do you think such an EU taxonomy for sustainable assets and financial products should include?

Highlight:

The taxonomy should reflect the goals of a long-term EU strategy on energy, climate, and the circular economy.

The complexity of the task of defining a coherent taxonomy should not be underestimated. It is known but not enough emphasized that these agenda, and more in general, the SDGs, are interdependent and there can be tradeoffs between specific targets. For instance, reducing GHG emissions by means of polluting chemicals leads to a tension between climate action (SDG 13) and the goals of protecting life below water and on earth (SDG 14,15). Further, increasing building energy efficiency by means of non-recyclable materials leads to a tension between the goal of climate action and the agenda on circular economy.

The taxonomy should be defined through a participatory approach to knowledge co-production among key stakeholders including academia and civil society. Academia needs to be involved because many issues are scientific in nature. In particular, the consequences of the taxonomy are far broader than finance. Civil society needs to be involved because the taxonomy will ultimately affect the public interest of citizens at large.

An EU public data infrastructure on investment chains in sustainable finance. Classification criteria for a product/asset should be measurable and verifiable. The taxonomy needs to look at: 1) the whole life cycle of products, 2) the supply chain of real sector projects, 3) the investment chain of securitised financial products. The classification of assets and the assessment of their level of sustainability requires the establishment of an integrated EU-wide data infrastructure on economic activities. In particular, in order to assign coherent scores to assets and portfolios it is necessary to account for the supply chains and ownership chains.

A taxonomy with a long-term horizon but not written in stone. The taxonomy should be intended to be long-term (i.e. future changes limited to the lower branches of its tree structure). However, the taxonomy should not include sustainability scores per se, because these are dynamic in nature as they depend on scientific discovery and emerging tradeoffs among objectives. The sustainability scores should be multivariate and time dependent, projecting several years in advance, reflecting realistically the transition of the industry.

Question 3. What considerations should the EU keep in mind when establishing a European standard and label for green bonds and other sustainable assets? How can the EU ensure high-quality standards and labels that avoid misuse/green-washing?

Highlight:

Financial complexity may conflict with a credible taxonomy. While a certain level of financial complexity is beneficial in the securitisation process, too much complexity leads to moral hazard. Taxonomy needs to be transparent with respect to securitised products and a process of monitoring by an EU public agency. The perverse incentives and moral hazard observed among actors around the credit rating agencies in the run-up to the 2008 subprime crises should be proactively avoided.

We need an EU public institution that gathers data and maintains the data infrastructure to be used to assess the sustainability of financial products.

There is a need for more granular company and project data. For instance, the current NACE code classification of economic sectors is not suitable to discriminate e.g. green and brown economic projects.

There is a need for more disclosure of financial network data (i.e. investment/lending chains). For instance, data on ownership of equity and bonds and exposure to loans is not available or not available in the necessary detail and frequency to assign a reliable rating to most financial instruments and to the portfolios of the largest financial institutions.

The current limitations on the availability, even to policy makers, of financial network data (i.e. investment/lending chains) poses a threat both to stability and sustainability.

A labelling system based only on a taxonomy is known from knowledge management science to be vulnerable to misuse. The design of the labelling system should be analysed carefully and should take into account the state of the art in addressing this kind of problem.

Question 4. What key services do you think an entity like "Sustainable Infrastructure Europe" should provide, more specifically in terms of advisory services and connecting public authorities with private investors?

Highlight:

The proposed “Sustainable Infrastructure Europe” entity should be thought of as a mission-oriented financial institution, with sustainable finance objectives. Its responsibilities should include:

- Supporting the developers of new green technologies in gathering funds
- Screening applications and monitoring financed projects, including after the granting of funds
- Financing directly (or indirectly) sustainable investments (financial intermediation) with close attention to risk from securitisation

Other issues:

- PPPs at the local level have been the object of many controversies because of the nexus between local political actors and local businesses in several countries. Attention should be paid to the transparency of the tender process. Even more importantly, communities need to be part of the PPP’s design and its negotiation in order to avoid inefficiency in the use of public funds and damages from a social and environmental perspective. As a relevant case study, see the new PPP model by DOLFINS partner PlusValue with the EIB at the project Ospital Grande in Treviso, Italy.
- The EU should build on the in-depth expertise of the EIB on how to scale-up investments as set out in the Investment Plan for Europe.
- The EU should also consider to what extent synergies with national promotional banks and governments could be promoted in order to enable the Investment Plan for Europe to play a critical role in the ‘sustainable infrastructure challenge’.

Question 6. What key levers do you think the EU could use to best align the investment and analyst community with long-term sustainability considerations in the real economy?

Highlight:

We need a combination of incentives and compliance. But both require appropriate metrics because decision makers can act upon only what they can measure. Therefore, here is a preliminary list of levers:

- Establish a stable policy framework in the areas of energy, infrastructures and environment in order to make sure that revenue streams are predictable for market players while respecting interconnected SDG targets (e.g. GHG emissions, circular economy, biodiversity, etc.). Remove subsidies to sectors with obvious known externalities such as brown energy.
- Promote the extension of the standard metrics of risk and impact and foster their adoption as performance indicators:
  - Include climate risk (physical and transition) into standard Value at Risk and similar statistics (see e.g. Battiston et al. 2017).
  - Encourage (first on a voluntary basis) companies and investors to assess their climate impact, i.e. impact that the portfolio has on climate action. This can be done in terms of GHG emissions

(see Carbon Disclosure Project) or technological alignment (see the SEIMETRIC methodology by 2-degrees-investing).

- Develop new network-based metrics in order to incorporate indirect impact via supply chain and indirect exposure via investment chains.
- Adopt network-based metrics of financial systemic risk emerging from financial interconnectedness
- Adopt network-based metrics of financial systemic impact: contribution of institutions to systemic risk because of their interconnectedness (see the whole stream of work on systemic impact in financial networks from DOLFINS and other colleagues, in collaboration with ESRB and BoE).

Question 9. What would be the best way to involve banks more strongly on sustainability, particularly through long-term lending and project finance?

Highlight:

Financial policies and regulations aimed at promoting banks' credit supply to green projects (e.g., green capital requirements) can be a useful tool, but only if they go hand in hand with the introduction of a stable, EU-wide, green framework of economic and fiscal policies that promote the demand for green projects in the real sector, in order to avoid a 'green bubble'.

Question 11. What do you think should be the priority when mobilising private capital for social dimensions of sustainable development?

Highlight:

It is important to acknowledge that not everything social can be delivered by financial markets. This is why we have public institutions.

Because mobilizing capital results in changes in financial flows, it is important to pay attention to the fact that these changes in financial flows do not go in the direction to exacerbate the already worrying levels of inequality in the EU.

It would be very fruitful to engage scientists, social entrepreneurs and ESG investors into a discourse about opportunities and limits of social investment.

Question 12. Do you have any comments on the policy recommendations or policy areas mentioned in the Interim Report but not mentioned in this survey?

Highlight:

The Interim Report early recommendations about

1. **establishing an EU observatory, and**
2. **an EU-funded research program on Sustainable Finance**

are extremely important and they should appear as formal recommendations in the final report of the HLEG.

Indeed, the roadmap indicated by the HLEG Interim Report to establish a credible EU sustainable finance sector with a taxonomy, a labelling system and a vibrant pipeline of projects requires:

- EU-level, big-data infrastructure to maintain databases of sustainable finance assets and actors
- Authoritative, independent scientific and technical EU competence to develop and update metrics, models and methods in collaboration with policy makers. While collaboration with the industry is beneficial, conflicts of interest need to be limited and managed.

Therefore, the two recommendations are preconditions for the roadmap to work.

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