

EEFIG subgroup on impact of financial regulation on the availability of long-term funds by financial institutions

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This work is to be approached having in mind the following elements of context:

- The point of the financial regulation impacting the ability of financial institutions to provide long-term funds to EE projects was raised during the preparation of EFIG interim report.
- Long term was also the topic of an EU consultation last year, with a wider debate on how to foster the supply of long-term financing and how to improve and diversify the current system of financial intermediation.
- Tighter regulations have been developed following the recent crisis, with the aim of increasing the stability and liquidity of the financial sector. Basel III has led to tougher credit conditions in particular for long-term investments.

Why does long term matter for energy efficiency projects?

Because it is closely linked with:

- the ability to opt for ambitious or deep retrofits, which will have the most impact over time, but with higher upfront costs. These costs therefore need to be repaid over a longer period of time.
- an access made possible for more borrowers, with limited upfront payment capacity or repayment capacity (in particular for residential homes and multi-family condominiums).¹

The inputs collected in this subgroup aim at bringing some light on whether or not financial regulations are perceived as limiting the ability of deploying long-term funds, and therefore whether they can support in the particular case of EFIG energy policy targets, with more energy efficiency projects to be funded.

KEY FINDINGS: All EFIG participants consulted have confirmed that financial regulations do have an impact limiting the capacity to deploy long-term funds.

On the banking regulation side, the focus should probably be more on whether the capital adequacy ratios are appropriate for EE investments, ie not overly high for the underlying risks, therefore stressing the importance of a good assessment of those risks. Banks will still be needed, although investors are expected to play a bigger role, in particular in the EU's capital markets union project.

A recent research report released by UNEP FI with Cambridge University on Basel III shows how little environmental risks are taken into account in banking regulation, and how little link currently exists between financial stability regulation and environmental sustainability (where EE projects belong).

¹ Energy Posit'IF business plan includes financing as long as 20 years.

Although there is a search for more capital markets solutions at the European level, following insufficient bank lending and constraints on banks' balance sheets, we have inquired on both banking and investment's side. As indicated in the Klinz' report², it is critical that banks continue to play significant support of the long-term financing of the economy.

Institutional investors have a clear role to play in the future, but they do not have the years of expertise and know-how in the (project) risk management that banks have developed. In that context, there might be a risk that institutional investors as new comers in the financing of energy efficiency –among other new assets expected to be increasingly packaged and presented to investors- will focus on clearly identifiable low risks, (ie flight to quality), leaving the banks with the funding of higher risks, ie more capital requirements.

On the banking side, the new restrictive prudential framework is expected to result into a permanent reduction of long-term assets in bank balance-sheets, as those long-term assets are expected to absorb a significant amount of banks' regulatory capital. Therefore, with a target of more financing for EE projects, including long-term ones, it will be key to make those assets attractive to investors, in order to enable funding of such projects, and subsequently free banks' capital for new loans. A special attention should then be given to how investments or the refinancing of banks by investors take place for EE financings, with the proper transparency facilitating long-term investments.

NB: this note **applies to all financial institutions**, including the particular case of development banks, funding agencies and public long-term investors, although these have a different business model, long-term and usually counter-cyclical.

This subgroup benefitted from the input from UNEP Inquiry, as well as from Pr Kern Alexander's recent report for UNEP FI on Basel III and the cover of environmental risks.

UNEP Inquiry provided us with its thoughts with regard to the flow of capital towards energy efficient investment options, guided by two key factors:

- on the financial demand-side, the existence of market and policy frameworks that attract risk-adjusted finance (eg through energy efficiency product standards, carbon pricing)
- on the financial supply-side, the existence of market and policy frameworks that integrate long-term sustainability factors so that risk-adjusted finance flows towards energy efficient options. These interventions are needed to overcome market failures such as short-termism, information failures, misaligned incentives, unclear responsibilities.

Five broad categories of financial supply side interventions can be identified, involving specific

² Wolf Klinz was the Rapporteur of the report on the long-term financing of the economy, adopted by the plenary session in Strasbourg on 26 February.

regulation as well as market norms & standards

a) Capital requirements: A range of financial institutions are governed by capital requirements to ensure stability and solvency. At present, these do not incorporate environmental costs (eg carbon) or environmental benefits (eg energy efficiency). In the case of property financing, for example, there is a compelling case for exploring the adjustment of capital requirements to integrate the energy efficiency of the building: higher energy efficiency means lower outgoings, thereby becoming a better credit risk.

b) Responsibility & risk: In the EU, current regulatory definitions of the responsibilities of financial institutions and in particular their management of risk does not explicitly include sustainability factors (including energy efficiency). A case in point is the fiduciary duty of asset owners and managers where outdated market interpretations can prevent institutions from effectively integrating sustainability factors. In key emerging economies, such as Brazil, regulators have introduced formal requirements for banks to have formal systems for socio-environmental risk. Many financial institutions in the EU have adopted voluntary standards, but but these are not necessarily comprehensive or focused enough to drive energy efficiency.

c) Client relationships: Along the financing and investment chains, there is still a lack of rigour with which financial intermediaries seek to understand and meet the sustainability requirements of their clients (including energy efficiency): sustainability is not normally incorporated within definitions of 'know your customer' or 'treat your customer fairly'. Integrating sustainability/energy efficiency into routine client relations - eg loan requests, investment advice - would help to formalise the process and reveal latent customer demand.

d) Transparency & Market Discipline: Corporate disclosure of sustainability factors has been improving steadily - and the EU has recently passed new legislation on non-financial reporting. Transparency is much less well developed for financial institutions, particularly in terms of the sustainability performance of the supply of capital. Again, voluntary principles are in place, but often do not deliver the necessary granularity of detail to drive accountability on critical issues such as energy efficiency.

e) Systemic Risk: Sustainability is a positive asset for long-term financial and monetary stability. However, few financial regulators and central banks are currently evaluating how critical sustainability factors (eg energy security/efficiency) are impacting key economic & financial trends, cycles or events. Energy in particular plays a powerful role in inflation, productivity, disposable income, balance of payments (and thereby currencies) as well as inequality. Regulators charged with overseeing the integrity of the financial system need to extend the scope of their monitoring to include energy efficiency - thereby providing important signals to capital markets.

This is an emerging agenda - with an opportunity for the EU to take a concerted approach that supports the creation of the capital markets union and the long-term recovery of the EU economy.

A recent research report sponsored by UNEP FI³, in collaboration with the University of Cambridge, on “Stability and Sustainability in Banking reform: are environmental risks missing in Basel III?” brings additional light to the link between banking regulation and environmental risks, ie indirectly including the treatment of green assets such as energy efficiency loans. According to this report, Basel III narrowly covers environmental risks⁴. It explains how systemic environmental risk is currently not captured in Basel III, as the regulatory framework is not used in its full capacity. And it includes in its recommendations that “green” assets or environmentally sustainable economic activity be encouraged.

It is true that the Pillar I of Basel III⁵ is more favourable with lower risk weighting to short-term recourse loans than longer-term project finance for instance. When it comes to banking regulation and long-term, usually reference is made to Basel III's Pillar 1. Yet, governance and risk issues, ie Pillars II and III, seem to outweigh the influence of cost of capital.

This leads to a new look at Basel III and its potential impact/limitation on the availability of long-term funds. And applied to our very case of energy efficiency financings, it means that to go further with the most appropriate capital ratio requirements, it is on a finer assessment of the underlying risks of such financings that the focus should be.

Some historic data on loans in France⁶ could come and support the assessment of the proven low risks of treasury loans for energy efficiency home retrofits, coming as the safest loans, with 0.3% to 0.5%, for 5 to 10 year-loans. Similar results have already been produced in the US, with very low default rate on large portfolios of property loans when including energy efficiency work.

As a conclusion, there is a need for more concerted policy-led and market-led activities, to push in a consistent way the drivers for the demand of buildings EE refurbishments, and those of investment supply, in particular long-term investments.

In order to enable more long-term financings needed for ambitious EE financings, further work shall be conducted to collect exact risk performance data of those financings. Potentially the access to the data available with on bill payment systems shall be useful too.

³ UNEP FI report launched mid October 2014 and available on its site:
<http://www.unepfi.org/fileadmin/documents/StabilitySustainability.pdf>

⁴ only touched on in its Pillar I with the environmental liability of toxic substances

⁵ Pillar I on enhanced minimum capital and liability requirements, Pillar II on enhanced supervisory review process for firm-wide risk management and capital planning, and Pillar III on enhanced risk disclosure and market discipline

⁶ In June 2014 BNP Paris' position paper for the Conference on the Financing of the Energy Transition