Public consultation on EIB approach to supporting climate action

March 2015

Key messages:

• +2°C being the accepted climate goal at EU and international level, the core climate criteria for the Bank should be explicitly ‘2°C investment criteria’, ensuring that the activities of the Bank are compatible with the climate target.

• The use of a volume-based target tends to make climate change a niche market, whereas the real challenge is actually to shift all bank activities to a 2°C trajectory.

• The Bank, maybe even more than other financial institutions, should mainstream its climate action, and not restrain its low-carbon focus to a limited set of actions.

• RDI, and more broadly its diffusion through SMEs, is expected to drive the development of a low-carbon economy. More coordination is needed between the Bank and institutions that monitor and forecast R&D trends, investments, and needs, at European/national/regional levels, so that key innovations are not left aside due to a misalignment of long-term and short-term interests.

• A better understanding of companies’ capital and R&D expenditures in low-carbon innovations is indispensable. Therefore, companies should improve disclosure of this data and institutions such as the EIB should contribute to this progress by making disclosure a mandatory requirement for the Bank to make a financial commitment to a company.

• GHG emissions accounting at the financial institution level exhibits significant limitations. The carbon price used at appraisal stage is interesting, but probably lacks other forward-looking dimensions in the frame of the transition to a low-carbon economy. Therefore, a more relevant approach would be a type of stress test, where forward-looking scenarios would embed variables such as carbon prices and other macroeconomic variables.

• Partnerships and joint research programmes should be developed so that relevant projects can feed the Bank’s processes and activities.

• The EIB must prove that it is a best practitioner in its climate action and demonstrate its leadership position on climate issues based on best available methodologies. The Bank could incept coordination of public banks with economic and governmental agencies in order to promote a better articulation between financial practices and forward-looking macroeconomic analysis related to climate change.
**Volume-based lending targets versus cross-cutting climate goals**

The climate challenge for a bank such as the EIB is by definition mainstream: it comes with the financing of a low-carbon economy that is in line with the global climate target agreed by governments associated to the UNFCCC and by the European Union, which can be summarised as limiting global warming to \(+2\)\(^\circ\)C. As a consequence, the objective for the Bank should be to clearly contribute to reaching EU targets. As such, no single investment decision should depart from that goal. A volume-based target has the clear advantage of ensuring a minimum level of climate-related investments, but as soon as the target is not 100\%, it raises questions about the compliance of the remaining part with climate/EU objectives.

The use of a volume-based target tends to make climate change a niche market, whereas the real challenge is actually to shift all the bank activities to a 2\(^\circ\)C trajectory. Hence, it would be necessary to consider the whole portfolio of the Bank in order to address its relevance versus the target, and not only to focus on a niche, regardless how ‘green’ the niche is (and how big the niche is, unless it represents the quasi-totality). The precise balance between ‘green’, ‘not-so-green’, and ‘non-green’ activities is the important type of information needed to address the ‘climate-friendliness’ of a financial institution. The volume-based target is unable to inform this question: is the EIB portfolio in, over, or far below a 2\(^\circ\)C trajectory?

**2\(^\circ\)C investment criteria**

The Bank’s shadow pricing and emission performance standards succeeded to phase out the most carbon intensive projects of the pipeline (especially coal investments). But the Bank, maybe even more than other financial institutions, should mainstream its climate action, and not restrain its low-carbon focus to a limited set of actions. Increasing its financing to, for instance, renewables both within and outside the EU goes of course in the right direction, but it can be a negligible action if at the same time more financing goes to long lifespan infrastructures that indirectly need more high-carbon facilities and assets.

In general, all investment/financing decisions should be undertaken as a function of the climate constraints and economic demand over time under a 2\(^\circ\)C scenario. This is the general concept of 2\(^\circ\)C compatible investment criteria, which has been developed by the 2\(^\circ\) Investing Initiative (2°ii). 2°ii is currently contributing to a project launched by the German Ministry of Environment (BMU) aiming at developing criteria and guidelines for financial institutions to assess the climate compatibility of investments, i.e. whether they are in line with the +2\(^\circ\)C goal.

Such a 2\(^\circ\)C investment approach is needed to inform both the climate-friendliness of the solution the Bank is providing, and its level of risk under a 2\(^\circ\)C scenario. Indeed, international and EU governments committed to achieve the +2\(^\circ\)C goal, so many industries and infrastructures that rely on a high-carbon world will be potentially at risk under such a 2\(^\circ\)C scenario (cf. stranded assets narrative). Financing these assets today is equivalent to bet on a failure of climate policies and commitments at the EU and international levels.
Investment in RDI for a low-carbon economy

RDI, and more broadly its diffusion through SMEs, is expected to drive the development of a low-carbon economy. Nevertheless, some technical choices are left to the market, which is supposed to incept the relevant technologies at the right moment to replace high-carbon-20th-century technologies. The innovation chain in some industries is long and selective, but the time in front of us to tackle climate change is rather short, and there is little room for error. Because of barriers in the innovation chain and misalignments of long-term and short-term interests, key technological ruptures can be left aside by research, even though those ruptures might be necessary to achieve the 2°C goal. Therefore, a sound RDI supporting scheme would give preferential treatment (via long-term commitments, in order to incept the demand for capital at early stages of the innovation chain) to sectors and technologies as a function of their priority in 2°C technology roadmaps, and of the gap between current volumes of financing and estimated needs. For instance, electric propulsion engines or wind turbines now appear to be dynamic sectors where competition drives innovation efficiently, whereas the alternative to cement for construction seems neglected relatively to the GHG challenge for the sector. Identifying these needs and supporting the RDI in these sectors is a priority. Therefore, more coordination is needed between the Bank and institutions that monitor and forecast R&D trends, investments, and needs (cf. European/national/regional agencies and programmes related to SMEs and RDI [e.g. National R&D Institute for Prospective Technological Studies / Economics of Industrial Research & Innovation (IPTS/IRI), Executive Agency for Small and Medium-sized Enterprises (EASME), Advanced Monitoring and Coordination of EU R&D Policies at Regional Level (AMCER)], OECD R&D Statistics, International Energy Agency / Energy Technology Perspectives (IEA/ETP)).

Reporting and disclosure

On the other hand, it is difficult to assess the relevance of energy-intensive companies’ low-carbon strategies without having a clear view on their precise development plans. A better understanding of those companies’ capital and R&D expenditures in low-carbon innovations is indispensible for financial institutions to have a more pertinent view of the relevance of these companies in terms of their trajectory versus 2°C pathways. Therefore, an important step forward would be that industrial and technology companies improve their disclosure of such data. Institutions such as the EIB should contribute to this progress by making disclosure a mandatory requirement for the Bank to make a financial commitment to a company.

GHG emissions and 2°C emission pathways

The GHG emissions assessment at project level is one of the most practical measures to embed climate change issues in the decision making process. Nevertheless, GHG emissions accounting at the financial institution level suffers some serious limitations (cf. 2° Investing Initiative (2013), From Financed Emissions to Long-term Investing Metrics: State-of-the-art review of GHG-emissions accounting for the financial sector). It is very difficult to use GHG-emissions figures at the level of an institution, as they do not provide direct relevant information about the institution’s contribution to financing a low-carbon economy, nor about its exposure to carbon and energy transition risks. GHG emissions are a poor indicator of
‘climate performance’, as the reference usually considered with GHG emissions is the baseline trajectory, and not the targeted pathway of emissions (see Fig.1).

**FIG 1: Issue of baseline vs. target trajectory in assessing the GHG performance of a financial institution**

An aggregated GHG emissions figure at Bank level, for all existing assets of the whole portfolio, can be interesting as a kind of annual absolute impact on climate, but it is difficult to determine whether it is a good or a bad outcome. Moreover, its time evolution is not very significant: it is extremely reliant on the perimeter, which evolves continuously. To be more informative, the GHG indicator would need to be normalized by the socio-economic services delivered. Indeed, a decrease of absolute emissions can result from a variation of sectorial exposure rather than an increase of energy efficiency for the same underlying economic effect.

**From shadow carbon price to carbon stress testing**

The carbon price used at appraisal stage is interesting, but probably lacks other forward-looking dimensions in the frame of the transition to a low-carbon economy. The transition will result in an evolution of energy prices, offer, demand, and cost structure for a number of technologies and industries, which cannot be captured all together by the sole price of carbon. Therefore, a more relevant approach would be a type of stress test, where forward-looking scenarios would embed variables such as carbon prices and other macroeconomic variables. This would also allow assessing the relevance of some assets in specific future condition and identifying potential stranded assets (cf. 2°Cii project on carbon stress-testing (2015, ongoing)).

Clearly, such an approach would be relevant at the whole EIB portfolio scale, and not only at appraisal stage. Indeed, the stock of existing assets coming from the last two decades or more is probably more exposed to risks related to the transition to a low-carbon economy than the most recent ones, thanks to Climate Action implementation. A drastic evolution of carbon price or other parameters subsequent to ambitious climate policies in the next years would affect the existing portfolio with potential significant risk exposure / financial consequences that need to be assessed properly.
Due to the long-term exposure of EIB’s portfolio, the analysis of risks and opportunities linked with climate change needs to adopt a dual vision including both mitigation (carbon risk) and adaptation (physical climate risk) in its scenario approach. This combination of forward-looking economic analysis and climate/catastrophe modelling is not yet a standard tool used routinely by financial institutions. Nevertheless, it is now gaining significant interest and development (cf. Mercer, Climate Change Scenarios – Implications for Strategic Asset Allocation (2011, 2015); UNEP Inquiry – Aligning the Financial System with Sustainable Development: Pathways to Scale (2015); UN Climate Summit, Resilience – Integrating Risks into the Financial System: The 1-in-100 Initiative (2014)). Leading institutions such as the EIB should follow up such work, support existing initiatives, and involve their teams in internal projects for a better assimilation of these issues throughout the Bank activities.

**Connection and coordination with other stakeholders**

As seen in previous sections, the EIB can improve its climate action with a better connection with work and research being undertaken outside the Bank.

Partnerships and joint research programmes shall be developed so that relevant projects can feed the Bank’s processes and activities. For instance, the Sustainable Energy Investment (SEI) Metrics project lead by 2°ii under a European Commission Horizon2020 grant, which proposes to develop a set of climate performance metrics and tools for financial institutions, offers a good opportunity for organisations such as the EIB to follow the research, orient the project deliverables towards its own needs, and coordinate with other stakeholders.

From an institutional standpoint, more coordination appears to be needed with organisations that provide 2°C investment scenarios. Those could be very useful to the EIB in defining its climate strategy and developing 2°C compatible investment criteria. The work of organisations such as the IEA is very interesting but is quite disconnected from practitioners within the finance sector. The IEA 2014 World Energy Investment Outlook provided a first move in this direction, but is still not a handbook for financial institutions. 2°ii, which contributed to the IEA 2014 WEIO, is devoted to making this connection happen, so that organisations devoted to economic/energy/climate analysis and forward-looking assessments provide research and analysis that are adapted and useful to banks’ needs, and reciprocally be fed by practitioners.

Thanks to its unique position, the EIB could initiate coordination between public banks and economic and governmental agencies, such as EU Directorates, EU agencies, the OECD, the IEA. Financial practices and economic analysis would benefit from being more coordinated so that the macroeconomic and energy/climate expertise could be more adapted to practitioners. In particular, the translation of policy targets (at regional, national, EU, or international levels) into investment and financing patterns would be helpful for financial decision-making.
The power of the example

The strong institutional position of EIB makes it a natural leader for other institutions to follow suit. As a necessary condition for this to happen, the EIB must prove that it is a best practitioner in its climate action and demonstrate its position as a leader on the different issues highlighted before. Such a positioning has the power to motivate other public and private institutions to adopt same methodologies/commitments/disclosure/etc., and in fine have a real global positive impact in the fight against climate change.