SUSTAINABLE GROWTH IN A TRANSITION ECONOMY

A VIEW FROM THE ITALIAN AND SLOVENIAN BANKING SECTORS

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WHO REMEMBERS THIS FORMULA?

$$Y = A \times K^{\alpha} \times L^{\beta}$$

Hint: we discussed it at the 2018 edition of the IBF…

The equation above, in simplified terms, indicates that Total Output (Y) is a function of **Total-Factor Productivity** (A), Capital Input (K), Labor Input (L), An increase in either A, K or L will lead to an increase in output.

Five years on, **stimulating** Total Factor Productivity still remains a (or) **THE** key challenge for the economies of **Slovenia and Italy**.

- Meanwhile, adverse external developments made this goal more awkward: **climate change**, energy and food supply shortages, international crises**,** all these factors **suppress total productivity**
- **Resilience** (a buzz-word economists borrowed from physics) is intimately correlated with the growth of Total Factor Productivity
- **Resilience** is at the heart of the **EU Recovery Plan**…
- Concurrently, the quest for a **sustainable growth has involved the financial sector**

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…the question is: how can the financial/banking sector have a role in this?

A FINANCIAL & BANKING PERSPECTIVE….

….BASIC ASSUMPTION/POSTULATE OF REGULATORY FRAMEWORK : ***SUSTAINABLE FINANCE*** *ENSURES* ***SUSTAINABLE GROWTH***

Based on this equation, the EU and international regulators focused on **sustainable finance** through:

- Stimulating ***green assets*** in the banks' books *(**lending side**)*
- Making funding for banks and bond issuers **cheaper** when they qualify as **'green issuers**' *(**liabilities-borrowing side**)*, avoiding greenwashing and enabling cheaper funding for eligible issuers

Main pre-requisites/levers for banking industry

Two pillars:

- **Classify** activities in view of their environmental sustainability (TAXONOMY directive)
- Duty to **disclose** such financial information (DISCLOSURE directive)

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……*TAXONOMY* & *DISCLOSURE*: TWO PILLARS OF EU **FINANCIAL REGULATION** FOR **SUSTAINABLE FINANCE**…

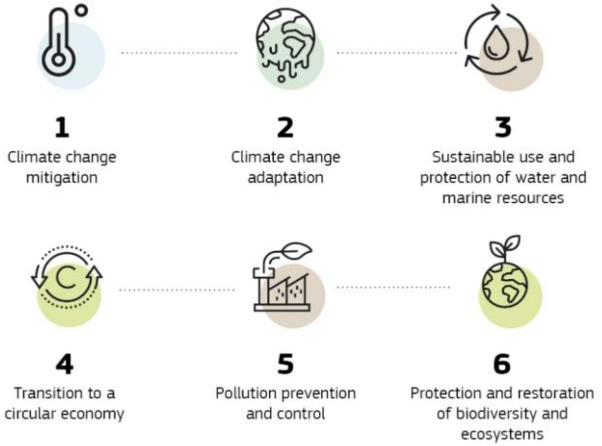
TAXONOMY *(EU regulation 2020)*

What the EU Taxonomy is
A classification system to establish clear definitions of what is an environmentally sustainable economic activity
Tool to help investors and companies to make informed investment decisions on environmentally sustainable activities for the purpose of determining the degree of sustainability of an investment
It's not a rating of the "greenness" of companies
What's not green is not necessarily brown. Activities that are not on the list, are not necessarily polluting activities. The focus is simply on activities that contribute substantially to environmental objectives.

DISCLOSURE *(EU regulation 2019)*

The **Sustainable Finance Disclosure Regulation** is part of the EU sustainable finance action plan

It lays down sustainability disclosure **obligations** for manufacturers of financial products and advisers to investors. It helps **identifying sustainability risks** for all market participants (*e.g.* asset managers, institutional investors, pension funds, financial advisers, etc.)



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Banks have been given an extra year to report their GAR; they must now do so from the end of December 2023, with BTAR disclosure to come in fron 2024. Industry bodies welcome the delay, but some argue that th timeline still needs ironing out.

95. For counterparties whose main activity is within the scope of the EU taxonomy, Figure 21 shows the GAR for both bank estimates and TAC estimates[98]. The average GAR is 7.1% for the bank estimate and 7.9% for the TAC estimate. It should be reiterated that only the TAC estimates should be treated as consistent and comparable figures[99].

. There is an on-going discussion on how banks could show the greenness of their activities in a comparable and harmonised way. In its recent advice to the European Commission the EBA proposed a common definition and methodology [95]. Taking into account the proposed methodology but also considering the availability of data in the pilot exercise, a conceptually

107. The 2020 EBA pilot exercise has been a learning exercise in which the EBA and participating banks (29 European banks) explored different tools to categorise exposures that could potentially be vulnerable to climate risks and map environmental friendly or 'green' exposures given the related data and methodological limitations that supervisors and the banking sector are currently dealing with. This report summarises the main findings of the exercise highlighting potential climate change related risks for the EU banking sectors and providing some estimates that should represent the starting point for future EBA work on climate risk.

108. Regarding the categorisation of banks' exposures from an environmental perspective, the repor lies ir (F), T expos

In terms of results, the amount of exposures to high carbon emissions reported by bank in the sample represents almost 25% of their corporate non-SME holdings. On the other hand banks showed more or less the same amount of exposures to obligors with low carbo emissions, which could counter-balance the effects of adverse environmental scenarios on th banking sector. However, forward-looking elements, like reliable and comparable transitio targets of obligors and the development of greener technologies in the production chains o counterparties' sectors, should be also taken into account before drawing a final a conclusio..

ty of EU banking exposures. Finally, improving the disclosure n strategies and developing interpolation methods for non-

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MAPPING CLIMATE RISK

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consistent approach has been employed. The green asset ratio (GAR) is constructed for each bank by dividing the green amount - available only for a subset of exposures - by the total original exposure[96]. The green amount is constructed using either the bank or TAC estimate.

...ission – Types of financial instruments to be considered

...alance-sheet exposures).

... green asset ratio (on balance sheet exposures) should include the following accounting categories of financial a... and equity holdings): financial assets at am... other comprehensive income, investment... financial assets designated at fair value thr... mandatorily at fair value through profit or lo... obtained by credit institutions by taking pos...

51. Financial assets held for trading should be ex... at this stage. Alternatively, separate disclosu...

ADVICE TO THE COMMISSION ON ARTICLE 8 TAXONO...

While **GAR** covers only **NFRD exposures** (from large institutions in the EU), **BTAR** expands the range to **include the EU non-NFRD and non-EU non-NFRD exposures**. This difference is the reason for the inclusion of the BTAR, i.e., so that companies/sectors/countries that do not fa under existing EU sustainability reporting standards have incentives to expand their "green" activities.

The **numerator of GAR** includes loans and advances, debt securities, and equity instrument not HfT. The **BTAR** includes all those plus exposures to EU non-financial corporations and non-EU non-financial corporations (not subject to NFRD).

Nevertheless, these last two types are included in the BTAR and GAR denominators, leaving the **same denominator for both ratios.** The denominator represents total assets excluding sovereigns, central bank exposures, and trading book exposures.

Institutions will be required to publish these ratios starting in **2024** for exposures up to year end 2023 for GAR and up to June 2024 for BTAR.

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EBA advises the Commission on KPIs for transparency on institutions' environmentally sustainable activities, including a green asset ratio

01 March 2021

- *The proposed key perfo... towards sustainability c... ...lders understand institutions' pathway*
- *Proportionality measur... eventually extend the sc... ...o facilitate institutions' disclosures and*
- *The EBA has developed... common proposal for c... ...ar 3 disclosures on ESG risks, including a*

EBA/Op/2021/03

26 February 2021

EBA Regular Use

Opinion of the European Banking Authority on the disclosure requirement on environmentally sustainable activities in accordance with Article 8 of the Taxonomy Regulation

Background

The EBA is publishir... ...eived in September 2020.

The green asset ratio **(GAR) is constructed for each bank by dividing the green amount** - available only for a subset of exposures - **by the total original exposure.**
The green amount is constructed using either the bank or TAC estimate (Taxonomy Aligned Coefficient, defined for eligible NACE codes).

FOCUS ON BANKING

THE GREEN ASSET RATIO – ONE OF THE MAIN OUTCOMES OF THE NEW REGULATORY FRAMEWORK

ADVICE TO THE COMMISSION ON ARTICLE 8 TAXONOMY REGULATION

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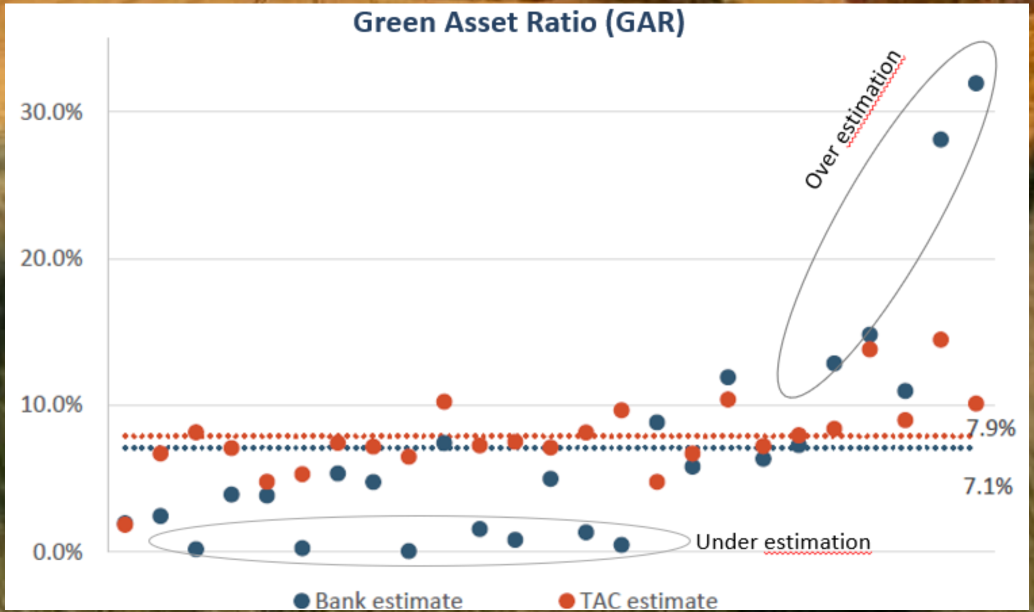
✓2021

Green asset ratio - Credit institutions should disclose their green asset ratio (GAR) to show the extent to which the financing activities in their banking book (including loans and advances, debt securities and equity instruments in the banking book) are associated with economic activities aligned with the EU Taxonomy and are therefore Paris Agreement- and SDG-aligned.

- ✓ *From end-2023 EU Banks have to report their GAR*
- ✓ *From end-june 2024 they have to report their BTAR (an extended GAR)*
- ✓ *Preliminary evidence from Dec.2020 survey*



: EBA – Risk Assessment of the European Banking System – December 2020, EBA – Mapping climate risk

The European Banking Authority issued a report on 21 May estimating an average Green Asset Ratio of 7.9% in a sample of 29 banks from ten EU states aligned to the

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WILL THE NEW REGULATORY FRAMEWORK INDUCE A ‘GREENER’ ATTITUDE FROM THE FINANCIAL/BANKING SECTOR?

PRELIMINARY EVIDENCES FROM THE ITALIAN MARKET

- Recent wholesale funding transactions, namely issuance of Italian sovereign bonds, revealed a **significant appetite** for ‘green’ sovereing bonds (‘***Green BTPs***’ – taxonomy eligible) (1)
- Since 2021 Italy made **3 successful placements** of Green BTPs (*last one in April, worth 10bn EUR, 8-year maturity – demand 4 times larger than offer*)
- first evidence is of a cheaper funding-cost for the issuer, confirming an appetite from institutional investors

(1) *BTP 8/31, YTM 3.97%; BTP 12/31 YTM 3.96%* ***BTP Green YTM 3.60% (quotation: MOT 14.4.23)***

- What about the retail-household market?
- *Memo: mortgages are eligible for Green Assets Ratio numerator*
- Comparative surveys, through mortgage-comparing engines, indicate that borrowing ‘green mortgages’ can be some 10 bps cheaper (2)

(2) enquiry on ‘Mutui on line’ run on 14.4.23

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- **ARE THE ABOVE EXPERIENCES REPLICABLE IN SLOVENIA?**
- *COUNTRY’S GREEN PROFILE INDICATE A POTENTIAL…*

…WRAPPING IT UP – KEY TAKEWAYS

- ✓ The quest for ***green/taxonomy-eligible*** placements is one of the specific contributions that the financial industry may bring to a sustainable economic growth
- ✓ The banking industry, owing to the new ‘green’ regulatory framework, is at the forefront of climate-change mitigation initiatives
- ✓ Such initiatives help enhancing total productivity, avoiding negative externalities which drag down economic potential
- ✓ Preliminary evidence has it that credit institutions and issuers who implement green regulations benefit from price advantages in funding
- ✓ Transferring this into favourable lending rates to eligible segments (mortages, climate change mitigators, circular economy) may in turn HELP TOTAL PRODUCTIVITY

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