Public financial intermediaries and climate change

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Research Context

- Ecological transition => strategic role of public financial intermediaries (PFIs) for their ability to finance large-scale, long-term projects that generate positive externalities.
- Great diversity of PFIs, but no typology or consensual definition
- Standard theoretical framework, based on market failures, is not adapted to the challenges of transition (uncertainty, systemic risk)
- Research questions:
  - Who are these PFIs and what is their role according to the literature?
  - What role have PFIs played in recent decades? The case of Europe
  - How can these players be classified and compared? A typology of PFIs, according to a multi-criteria analysis
  - What are the strategies of PFIs in the face of the energy transition?

Addressing the limitations of the theoretical literature on PFIs

- The standard literature has reduced the theoretical analysis of PFIs to a discussion on the foundations of public intervention based on market failures
- Two advances proposed in the article based on the pioneering analyses of Keynes, Minsky, Polanyi and Perez:
  - the role of the Entrepreneurial State assigning "missions" (ecological, technological) to the IFPs (Mazzucato), and not repairing the markets
  - a new financial paradigm adapted to the specificities of the climate crisis: the role of PFIs and the financial system is to face not only the lack of long-term investors, but also the uncertainty and systemic risk generated by the ecological transition (Aglietta)

Addressing the limitations of the theoretical literature on PFIs

- The empirical literature focuses on public (development) banks (PDBs) and ignores the diversity of PFIs
- Empirical work on public banks and government involvement in the banking sector leads to controversial results
- Existing work, based in particular on case studies (Griffith-Jones), attributes specific functions to PDBs:
  - countercyclical role; financing
  - public goods
  - structural transformations
  - catalysts for private finance.

The historical role of public financial institutions in European countries

- PFIs, in their diversity, have played a strategic role during the major stages of economic and social development:
  - Industrial Revolution (18th and 19th century): CDC(1815)
  - Great Depression of the 1930s: BIRD (1944)
  - Post-war reconstruction: KfW (1948)
  - Decline in PFIs during the neo-liberal phase
  - Financial crisis of 2007 and transition (Green Deal) => return of PFIs and what role for green finance?

Typology and overview of public financial intermediaries

- The absence of a universally accepted definition of PFIs
- A plethora of names and their limitations : *State-owned banks, public banks, state investment banks, government ownership of banks, policy banks*…
- Defining PFIs involves a multi-criteria analysis :
  - Public ownership and control
  - The existence of public policy missions (specific/large)
  - The nature of resources and financing instruments
  - The types of borrowers and sectors targeted
- Any type of financial institution that is owned and/or controlled by at least one state or public authority with an explicit legal mandate to achieve broader or narrower socio-economic objectives in a region or sector (the first two criteria corresponds to the lowest common denominator of PFIs)
- A heterogeneous group of institutions according to a combination of criteria
  - 2 main categories of PFIs: public banks and public investment funds
  - 7 sub-categories of PFIs

Strong discrepancy between the categories of PFIs

- **Size**:
  - The weight of public funds ($25 tr.) > the weight of public banks ($6.5 tr.).
  - PFIs' Asset under management < those of institutional investors ($90 tr.) and large private banks ($95 tr.).
- **Geographical**:
  - Private/public funds and private banks are the preserve of developed countries
  - We find public banks in middle-income countries
  - Green banks are only for developed countries (without BND).
- **Regulatory**:
  - Public banks are not subject to the same regulatory framework as commercial banks in Europe
  - The same goes for sovereign wealth funds and endowments, which have few regulatory requirements compared to institutional investors, with the exception of public pension funds.
- **Financing consraints:**
  - Public funds do not have short-term liquidity constraints related to their long-term savings/commercial banks and mutual funds;
  - Public banks are guaranteed by the State to obtain cheap resources

Strong discrepancy between the categories of PFIs

- **The fight against climate change:** Only public banks mention it in their missions, but in an unequal way
  - **MDBs** have rather broad mandates giving priority to the fight against poverty, hunger, health, education, while taking into account the climate emergency of some developing countries through the creation of dedicated climate funds.
  - **BNDs** have broad mandates within which climate is a priority while others have specific mandates such as infrastructure financing.
  - **Green banks** are the only ones to have a mandate exclusively dedicated to the environment but their field of intervention is limited because it is local and small
  - **Public investment funds** have been progressively encouraged to integrate environmental, social and governance (ESG) criteria into their investment decisions, following international initiatives (e.g. PRI, 2006, COP21 in 2015).
- **Consideration of non-financial performance:**
  - These banks can take them into account more because they are not listed and therefore not subject to the pressure of shareholders in terms of profitability.
  - By their mandate, they are not in the business of accumulating profits but rather of reinvesting to support new funding programs

European IFP and green finance: recent, diversified and unequal strategies

- An overview of the climate investment policies of European leaders: EIB ($606 bn.), KfW ($589 bn.), Norwegian sovereign wealth fund ($1180 bn.), Dutch pension fund ABP ($456 bn.), Oxford University Fund ($4 bn).
- A variable climate commitment:
  - a long-standing commitment to the SDGs for KfW (1980's) and the Sovereign Wealth Fund in terms of responsible investment (2004)
  - A recent climate commitment for ABP and Oxford with the integration of ESG criteria in investment decisions and the EIB with a climate plan (2015)
- More or less quantified investment objectives for public banks, while funds prefer declarations of intent (2015-2020)
  - The EIB has committed to devote 25% of its investments to climate change reduction and mitigation over the period
  - KfW has set an environmental commitment rate of approximately 35% of the total volume of promotional activities.
  - The ABP fund has announced a 30% carbon footprint reduction target for its portfolio

European IFP and green finance: recent, diversified and unequal strategies

- **Ambivalent and hardly verifiable policies**
- **Gaps between investment practices and statements of intent**
- ***The Norwegian sovereign wealth fund's responsible investment policy remains ambivalent*** :
  - Ongoing development of oil fields, especially in the Arctic
  - Substantial portfolio in the oil and gas sector at the end of 2018 ($37 billion)
  - Divestments only concern oil companies that do not invest in renewable energies, the oil majors such as Total, BP or ExxonMobil are therefore spared.
- ***The European Investment Bank :***
  - Alongside these green investments, the bank continued to lend €13.5 billion to fossil fuel-related activities
  - In addition, at around €25bn, the transport sector (with carbon-intensive projects such as airports and highways) dominated the volume of lending from 2015 to 2018, which is the same volume as energy efficiency and renewable energy combined

Conclusion and recommendations

- Climate investment strategies of leading European PFIs remain opaque and insufficient
  - A difficult assessment of the impact of PFIs climate policies due to the lack of extra-financial information (voluntary basis) and the weakness of the methodological framework and indicators.
  - The implementation of the climate commitments made since 2015 is not verifiable because of the voluntary and optional nature of the publication of quantified information on green investments relative to those in the fossil fuel sectors, on asset disposals or shareholder engagement (which is by nature difficult to quantify)...
- Recommendations
  - Mandate certain TCFD recommendations in annual reports on low-carbon and fossil fuel sector investments, divestments, environmental spending or provisions

Conclusion and recommendations

- Public banks
  - Their policies often involve delegating financing to private financial institutions or banks to finance small and medium-sized projects
  - Limits of green bonds financing:
    - a very marginal market compared to the investments needed to achieve the SDGs (only 0.4% of the outstanding global bond market in 2018 (Quang et al., 2019
    - the issuance of a green bond does not force companies to meet their commitment to use the borrowed funds for an environmental project, as is the case with any bond (Ekeland and Lefournier, 2019).
- Public investment funds:
  - They delegate all or part of their portfolios to private asset management companies present on stock market indices that are far from being located on a 1.5°C scenario trajectory
    - S&P500 would be on a 4.9°C; MSCI World (5°C); MSCI Europe (5.2°C) and the CAC 40 (5.2°C) (Stephens' (2018) study)
  - There is uncertainty as to whether ESG criteria are actually taken into account and how they rank in relation to financial criteria

Conclusion and recommendations

- **Recommendations:**
- Improving practices also requires a change in the governance of the PFI investment process in order to reduce the delegation of asset management or the granting of credit to private financial institutions that are more subject to the demands of short-term financial profitability.
- Indeed, the proliferation of delegations over the past thirty years has had a significant impact on the investment decision-making process.
- While these controls are legitimate in a delegation relationship, they will result in short-termist logics

Conclusion and recommendations

- Another avenue for future and complementary research : central banks.
  - The recent financial and health crises have shown their strategic role for the functioning and stability of the financial system.
  - An international network of central banks and supervisors on sustainable finance was created in this perspective on the occasion of the "One planet summit" held in Paris in 2017.
  - Until now, this network has mainly focused on the "greening" of financial regulation, leaving aside the issue of financing the transition. Yet central banks can play an important role in this area, if only by refinancing public banks.