

## Policy Brief

# Get your priorities right

## Europe must not underestimate the role of banks for the green transition

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EU policymakers and the financial sector have placed high hopes in forging a green capital markets union. However, the idea that capital markets could swiftly close the green investment gap ignores underlying financing structures. In Europe, the areas with the biggest funding needs rely on bank loans rather than financial markets and the recent banking turmoil is unlikely to change this. The reliance on banks will not abate any time soon as EU governments are dragging their heels on completing the capital markets union despite repeated promises. Since banks will largely finance the European green deal, the EU should step up its efforts to green the banking system and systematically make climate risks a core element of banking supervision, prudential regulation, and monetary policy.

**Big hopes rest on green capital markets.** No day passes without [central bankers](#), [regulators](#), [lawmakers](#) or the [financial sector](#) praising the benefits of integrated financial markets in funding Europe's transition to a clean energy economy. The most recent example is the [Green Deal Industrial Plan](#) that includes hardly any fresh public money but a bold reference to the potential of the capital markets union for securing a successful net-zero transformation. There seems to be a consensus that tapping into the vast volumes of mainstream private finance and redirecting it towards climate action could plug the European investment gap.

**Creating a single market for capital is imperative for consolidating euro area architecture.** Deepening the integration of financial markets would be highly beneficial for private risk-sharing within the European monetary union, foster financial stability, and bring efficiency gains for investors. More integrated markets could also help banks to diversify their cross-border asset holdings and enlarge their investor bases. Last but not least, it would make Europe more attractive for foreign investment and strengthen the international role of the euro. No wonder that the [presidents](#) of five EU institutions have called for „courage and openness“ to overcome financial market fragmentation.

**Despite great ambitions, the European capital markets union is making little progress.** Indeed, Europe has taken only [small steps towards](#) overcoming the national fragmentation of its capital markets. [Minor improvements](#) are in the pipeline, but core reforms such as the harmonisation of company, tax and insolvency laws now appear further away than ever. Difficulties in mobilising collateral on a cross-border basis and discrepancies in the execution of judicial decisions as well as delays in bankruptcy processes prevent capital markets from unlocking their full potential. As a result, financial markets are still [less developed](#) than in the US and smaller companies and innovative start-ups often struggle to access private capital.

**Europe cannot ignore the importance of banks for the European Green Deal.** While public debate focuses on capital markets, large parts of Europe's transition to a clean energy economy rely on bank credit and the [recent banking turmoil](#) is unlikely to change this. Banks are the main financing source of European companies as bank loans account for 75% of [corporate borrowing](#) and bond markets for only 25%. What's more, in other priority areas of the green transition, such as energy efficient residential housing, it is predominantly banks that provide the necessary funding. Therefore, the EU should step up its efforts to green the banking sector. This will be quicker and more effective than betting on a European capital markets union that is still far from being completed.

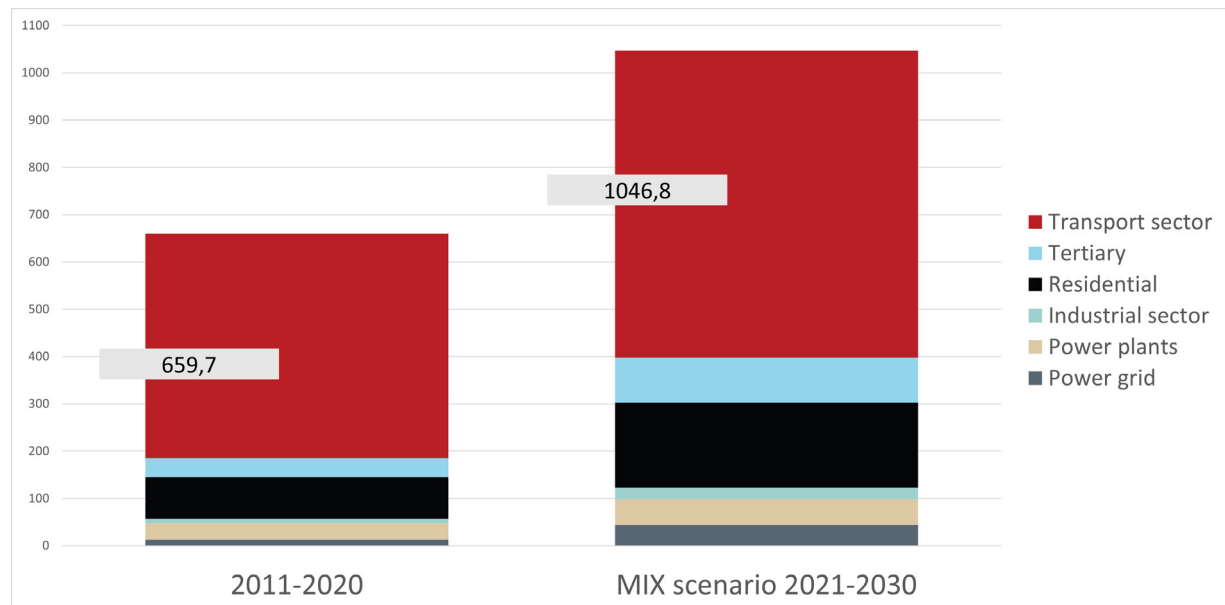
**Europe needs greener banks to fight climate change.** Despite signing up to net zero pledges, banks are far from phasing out their high-carbon investments. Beyond policymakers' apparent reluctance to enact strict climate laws putting the real economy on a clear decarbonisation trajectory, a main reason for continued investment in fossil fuels is the ignorance of climate risks in the EU banking system. By not treating their fossil fuel exposures as 'higher risk', banks' capital reserves fail to cover all climate risks and put the financing of clean projects at a clear disadvantage. Work on greening bank lending has started, but hardly matches the required urgency.

**This paper therefore makes proposals to systematically integrate climate considerations within bank lending.** Banking supervisors should urge banks to properly manage climate risks, lawmakers should require banks to align their business with the green transition, and the ECB should ensure its monetary policy does not contradict EU climate goals.

## **1 Green investment gap and current financing structures in Europe**

**The investment challenge ahead is enormous.** To accelerate the transition, the EU must invest massively in green. Simply reallocating existing financial flows from "dirty" to "clean" is not enough. To reach the goal of reducing greenhouse gas emissions by at least 55% by 2030, the EU needs to nearly double investment. Figure 1 illustrates the estimates of the European Commission for delivering on the Green Deal objectives: investment in the transport sector up by roughly a third, in power plants by more than two thirds, in housing renovations and transition investments in the tertiary and industrial sector doubled – and in power grids more than tripled.

**Figure 1: Investment needs to deliver on the European Green Deal objectives on climate and energy policy compared to previous investment (EUR bn, per year)**



Source: European Commission, 2021, [Impact Assessment](#) accompanying the Renewable Energy Directive, Table 7. Annual investment needs 2021-2030 according to the MIX scenario that relies on both carbon price signal extension to road transport and buildings and intensification of energy and transport policies.

**Governments struggle to identify funding sources for the European Green Deal.** The public sector will have to act as a catalyst for the transition, either through direct public investment or other means such as co-financing, private-public partnerships or state guarantees. But in the face of budgetary constraints, EU capitals are counting on private money. According to [national energy and climate plans](#), the GDP-weighted share of private green investment [foreseen](#) in the period 2021-2030 amounts to 75% of total additional green investment needs in the EU. However, most governments fail to specify where the private money is supposed to come from and vaguely mention ‘green finance’ instead.

**Capital markets’ role in green investment financing is limited.** Research on the financing structures of many sectors vital to a clean energy economy is scarce. What we know implies that capital markets contribute little to funding the European Green Deal. Some large listed corporates active in high-carbon sectors such as [cement](#), [chemicals](#) or [automotive](#) may well be seeking funding opportunities in capital markets to green their business, but they remain a minority. Most investment in sectors such as energy networks and rail infrastructure – [natural monopolies](#) – relies primarily on the public purse. Crucially, all other green investment needs are mainly met by bank credit.

**Banks are crucial to financing priority areas of Europe’s green transition.** First, the bulk of [small and medium sized enterprises](#) (SMEs) active in the industrial or services sector are not quoted at the stock exchange and rely on bank loans for external financing. Second, banks are the key funders of building retrofits. More than two thirds of the EU population live in an owner-occupied [home](#). To improve its energy efficiency, they will tap their local bank for a mortgage loan. The same is true for landlords that are not listed property companies. Third, for renewable power plants, [the financing structure of choice](#) is non-recourse project finance. Under this special financing method, banks predominantly provide loans which are secured by project assets and paid back from project cash flow. The era when large utilities used corporate finance to build big coal or gas power plants is long gone. A low-carbon energy system relies on decentralised solar and wind power plants and the smaller

the project, the more likely it will be funded through project finance. Fourth, banks even play a role in financing sustainable investment by large companies such as in [green steel](#).

## 2 The EU sustainable finance agenda should put banks at the centre

**While EU governments are dragging their heels on completing the capital markets union and banks provide the bulk of green asset financing, the EU regulatory agenda is focused on greening markets.** To reorient financial flows towards a low-carbon economy, the European Commission has put forward a sustainable finance [strategy](#) that builds on both mandatory disclosure and voluntary action. Among the most important legislative pieces are the EU Green Taxonomy, the Sustainable Finance Disclosure Regulation (SFDR), the Corporate Sustainability Reporting Directive (CSRD), the European Green Bond Standard (EUGBS), and the forthcoming European Single Access Point (ESAP). Their main objective is to provide investors with information on the sustainability of economic activities and financial products so they green their investments.

**Expectations about the change that mere transparency can deliver are inflated.** Mandatory disclosure regimes are crucial for investors who want to align with the needs of a greener economy. They also help the financial sector, including banks, better assess and manage climate risks. However, increasing the availability of sustainability data is a necessary but not sufficient condition to alter investment decisions. The belief that disclosure will drive investors to voluntarily divest from high-carbon assets and switch to clean technologies has been severely [disappointed](#). On the one hand, each market participant is left to reflect the sustainability information in their financial decision-making and some actors prefer to maximise short-term profits over saving the planet. On the other hand, the combination of growing demand for sustainable investments and rapidly evolving markets creates ample room for [greenwashing](#) that harms investor confidence and has no positive impact on the environment. While environmentally conscious retail investors intend to make a positive impact, most asset managers treat environmental, social and governance (ESG) factors as just an additional input in their portfolio strategy.

**Given the importance of banks in funding the transition, Europe should get serious about greening its banking system.** Instead of hoping for transparency to change investor behaviour, it is time to systematically incorporate climate risks in the work of banking supervisors, in the capital requirements of banks, and in the monetary policy of the ECB. These measures directly impact investment decisions as they change the relative financing costs of green and brown funding. They put an end to the artificially cheap financing of unsustainable projects and at the same time render sustainable investment alternatives more attractive. Last but not least, they provide a strong incentive to reduce exposure to potential losses from climate risks.

**Banks fund the European economy, but too few sustainable projects.** Despite the evident [climate emergency](#) and the urgent appeal of the [International Energy Agency](#) to immediately stop investment in new fossil fuel supply projects, banks largely ignore climate change risks and keep on funding high-carbon sectors. New [data](#) shows that just 7% of global banks' energy financing goes to renewables, 93% still flows into fossils. In the EU, the 22 largest banks are [estimated](#) to hold EUR 221 billion in fossil fuel assets. In its 2022 [climate risk stress test](#), the European Central Bank (ECB) found that most banks do not have robust climate risk stress-testing frameworks and lack relevant data. This is alarming news for financial stability as the green transition will make the fossil fuel sector lose the larger part of its value and lenders will have to bear these losses. And it is concerning because each euro going into brown assets is unavailable for sustainable projects.

**To preserve the planet and maintain financial stability, orderly divestment from fossil-fuel assets must start now.** Bold action is imperative, because natural disasters and going beyond climate tipping points may lead to sudden large shifts in [perceptions of risk](#). The resulting sharp repricing shock could lead to devastating [fire-sale dynamics](#) disrupting the entire financial system. To prepare for such green swan events, banks ultimately have no alternative than divesting from high-carbon assets. Banking [supervisors](#), [regulators](#) and [central banks](#) recognise the need for action and have launched initiatives to consider climate change in bank lending. However, the next section will show that these attempts lack ambition, speed, comprehensiveness, determination, rigour, and a legally binding character.

**The current lack of standardised sustainability data must not prevent regulatory action.** Despite numerous transparency initiatives launched recently, the available climate risk data remain [insufficient](#) in terms of completeness, availability of historic information and representativeness of future evolution. In the same vein, the [definition](#) of sustainable economic activities is imperfect due to undue [politicisation](#) and the gradual inclusion of [additional sectors](#). Still, the urgency of climate change and the risk of climate tipping points call for precautionary measures to incorporate climate change considerations when it comes to providing bank credit. The risks of inaction are far greater than those of acting on the basis of [patchy data](#). Standardisation and availability of climate data will improve over time, and this will allow regulators to fine-tune measures and boost the toolbox.

**Lawmakers should intensify work on greening banks but not compromise on financial stability.** Aware of their importance in the green transition, banks are [pushing](#) for regulatory relief that would free capacity for additional lending to finance a clean energy economy. In particular, banks call for regulatory ease when off-loading credit risk on capital markets via [securitisation](#). However, these claims are misleading for two reasons. First, since banks currently hold a total of €4,200 billion in the Eurosystem's deposit facility, lending capacity can hardly be considered a constraining factor for green bank loans. Second, it is highly [questionable](#) that lower prudential requirements would lead to higher lending. Without any guarantee that banks use the freed-up capital to fund sustainable projects, lighter regulation does little to help the green transition but may well increase financial instability. Against the backdrop of [recent bank failures](#) in the US and Switzerland, which underline the fragility of the banking system, EU policymakers would be well advised to strengthen the resilience of banks rather than create new vulnerabilities by relaxing prudential regulation. To ensure that banks are part of the solution, Europe should significantly step up its efforts to make the banking sector finance clean technologies, not more dirty ones. The following section suggests how to achieve that.

### 3 How to systematically tailor the EU banking system towards sustainability

It's crucial to ensure banks finance truly green investment. There are three levers to pull: banking supervision, prudential regulation, and monetary policy. The following section shows that attempts to consider climate change in all of those areas have been taken, but there is substantial room for improvement.

#### 3.1 Making the most of banking supervisors' existing mandate

Table 1: Actions to consider climate change in bank supervisory policy

Measure	Application date
EBA guidelines on loan origination and monitoring including the requirement to incorporate ESG risks in the banks' risk management	Since June 2022
ECB sets deadlines for banks to meet supervisory expectations on climate-related and environmental risk	Gradually until end-2024
ECB to ensure that also Less Significant Institutions supervised by National Competent Authorities in the Banking Union abide by ECB's supervisory expectations	Asap
EBA to work with National Competent Authorities outside Banking Union to apply measures similar to the ECB's supervisory expectations	Asap
All bank supervisors in the EU to apply large exposure limits to address excessive climate risk taking by banks	Asap

Source: Own illustration. Colour code: *Measure in force but not enforceable* / *Measure enforceable but with limited scope* / *Measure that should be taken as soon as possible*.

**The current ignorance of climate risks endangers the planet and financial stability.** In a perfect world, climate risks would be adequately reflected in CO2 pricing and through that route provide incentives for a shift towards a low-carbon economy. But the real world looks very different. The current practice of not treating banks' fossil fuel exposures as 'higher risk' enables banks to provide financing at artificially lower rates to fossil fuel companies. This 'subsidy' puts the financing of sustainable and transition projects at a clear disadvantage and endangers banks' resilience as climate risks are insufficiently covered by bank capital.

**A first avenue to make banks finance cleaner investment lies within the realm of supervision.** Aligning banks' business with the green transition requires profound legislative changes that will be discussed in the next section. But current prudential legislation allows supervisors to force banks to consider climate change risks. If consistently applied, supervision can be a powerful tool to deter banks from financing risky, carbon-intensive activities.

**The systematic inclusion of climate-related hazards in banks' risk management can act as a kind of CO2 shadow price.** Banks' capital requirements depend on their risk profile: the greater their risk exposure, the more costly capital they need. Requiring banks to hold more capital when granting credit to unsustainable projects or when buying shares and bonds of high-carbon companies provides them with strong incentives to divest from assets that are at risk of being stranded and invest in sustainable undertakings instead. Since the inclusion of climate risks in asset pricing serves not only the green transition but also aids banks' resilience and financial stability more broadly, financial regulators have launched early initiatives in this regard.

**Financial supervisors have started to make banks consider climate-related risks.** To cater for the specific risk-profile of individual banks, supervisors can ask each bank to hold additional (Pillar 2) capital for any risk they regard as inadequately covered by the (Pillar 1) capital requirement. The ECB in its function as supervisor of the biggest banks in the



banking union recently [announced](#) that banks under its remit must progressively meet all supervisory expectations laid out in its [Guide](#) on climate-related and environmental risks by the end of 2024. Already in 2022, the ECB required a small number of banks to hold additional capital to address their climate risk exposure. Complementing the ECB's work, the European Banking Authority's (EBA) [Guidelines](#) on loan origination and monitoring require all banks in the EU to incorporate ESG factors in their risk management policies.

**Enforcement of supervisory measures is not guaranteed across Europe.** While the ECB and EBA initiatives are welcome, they both face shortcomings that limit their power across the EU. On the one hand, the EBA guidelines apply to banks across all EU member states, but are, by their very nature, unenforceable. Banks and national competent authorities may deviate without risking any sanctions. On the other hand, the ECB does indeed want to enforce its expectations of players' behaviours, but it directly supervises only the [110](#) biggest banks in the banking union. While the ECB's supervisory expectations in principle apply also to the more than 2000 [smaller banks](#) in the banking union, it is up to national competent authorities to make them live up to these. In any case, the ECB's supervisory expectations carry no weight with banks and supervisors outside the banking union. This raises concerns for the level playing field of banks in the EU but also puts at risk the green transition itself.

**Not all banking supervisors in the EU are supportive of Europe's climate ambitions.** For instance, financial authorities in Czechia and Bulgaria have taken [no steps](#) to incorporate ESG risks into their prudential framework. Both countries have shown no appetite yet to join the network for greening the financial system ([NGFS](#)), which organizes cooperation and exchanges among monetary and macroprudential authorities around the world. Another example is [Poland](#), where the Financial Supervision Authority is member of the NGFS but the National Bank of Poland has issued warnings that an over-hasty transition to renewable energy sources, in which entire "brown" sectors could be rapidly destroyed, could jeopardise the stability of the financial system. Where supervisors fail to urge banks under their remit to limit climate-related risks, this creates distortions in the internal market and undermines Europe's ambitions on climate.

**Supervisors across the EU must systematically integrate climate-change related risks into banks' capital requirements.** As revealed by the ECB in its [climate stress test](#), small domestic retail lenders are the most reliant on income from greenhouse gas emitting sectors. To help the green transition and make banks more resilient to climate change, the ECB should work closely with national competent authorities to ensure that smaller players within the banking union abide by the ECB's supervisory expectations on the prudential treatment of climate risks. What's more, the EBA should use the ECB's supervisory expectations as a template for the [forthcoming](#) EBA guidelines on the incorporation of ESG risks in banking supervision so that supervisors outside the banking union also comply with them.

**Large exposure limits could address excessive climate risk taking by banks.** In concrete terms, bank supervisors inside and outside the banking union should apply large exposure limits to address excessive climate risk taking. Learning from the ECB's [climate stress test](#), which found that emissions from entities financed by banks are often concentrated in a few large emitters, the ECB and national supervisors should make use of their powers enshrined in Article 104 (1) letter e) of the Capital Requirements Directive ([CRD V](#)) to "restrict or limit the business, operations or network of institutions or to request the divestment of activities that pose excessive risks to the soundness of an institution".

### 3.2 Amend prudential regulation to align banks' business with the green transition

Table 2: Actions to consider climate change in prudential regulation

Measure	Application date
Require banks to disclose their climate-related risks (adopted under CRR2)	2023
Clarify the responsibility for banks and supervisors to integrate climate change into banks' risk management and capital requirement (proposed under CRD VI)	Forthcoming
Require banks to draw up transition plans and empower supervisors to enforce them (proposed under CRD VI)	Forthcoming
Introduce mortgage portfolio standards that require banks to increase the energy performance of buildings covered by their mortgages (proposed under EPBD)	Forthcoming
Introduce prohibitive capital requirements for banks when financing new fossil fuel projects	Asap

Source: Own illustration. Colour code: Measure adopted / Measure proposed by the European Commission / Measure that should be taken as soon as possible.

**To promote green investment, the second lever to pull is prudential regulation.** The purpose of prudential regulation is to ensure banks' resilience against any kind of risk. Prudential regulation must not be misused to incentivise specific economic policies. But integrating climate-related risks into the risk management of financial institutions serves the very purpose of prudential regulation and helps shift money from dirty to clean activities. Complementing supervisors' existing powers described in the previous section, amendments to European legislation are required to fully align banks' business with the transition to a clean energy economy.

**Greening banking regulation is not a new concept.** The last review of EU banking rules (CRR2) introduced the requirement for large, listed EU banks to disclose information on their [ESG risks](#). The disclosure requirement adopted in 2019 kicks in this year, with a first reference period of 28 June to 31 December 2022. Within the latest, ongoing overhaul of EU banking rules, the European Commission proposed clarifying in the legal text (CRD VI) that banks' responsibility to measure and manage risks clearly includes [climate-related](#) risks. Bank supervisors are already free to ask banks to hold additional Pillar 2 capital for any risk they see that is not covered by Pillar 1 capital requirements (see section 3.1 above). If adopted, the amendment will provide legal certainty for banking supervisors to go ahead and act against banks that ignore their climate change risks.

**Getting serious in the greening of prudential regulation requires bolder measures.** The EBA has recently [acknowledged](#) very clearly the tremendous risks that a net zero transition pathway poses to financial institutions exposed to fossil fuel assets. It therefore seems warranted and in their own interest to prevent banks from investing in new fossil fuel projects. An easy way to enact this would be to apply a 1250% risk weight to those dirty assets, which basically means that for €1 of credit going into a new fossil fuel project, banks must hold €1 of capital. In line with the inherent loss risk of fossil fuel projects, such a "[one-for-one](#)" rule would make bank investment in new dirty assets prohibitively costly and thus unattractive. The European Parliament recently [discarded](#) the introduction of a one-for-one capital requirement for bank loans for new oil, gas and coal projects. The next occasion for inserting such an obligation will be after June 2023 when the [EBA](#) is expected to issue a report on the integration of environmental risks into Pillar 1 minimum capital requirements.



**Better safe than sorry.** Opponents of capital requirements for banks' climate risks argue that those risks cannot be properly measured at this stage due to a lack of data, complexity, and uncertainty. However, using the common notion "If you can't measure it, you can't manage it" to oppose climate considerations in prudential regulation is a bad and in fact dangerous excuse. First, this infamous rule does not apply in other parts of prudential regulation. Take for example the calculation of banks' capital requirement for operational risk that takes the three-year average of certain items in the profit and loss account (net interest and net commissions received, the trading result, and other operating income) and then multiplies this "relevant indicator" by a fixed factor of 15%. Using historic average values of randomly chosen items in the profit and loss account can hardly be qualified scientific or accurate and its informational value for predicting the real operational risk going forward is limited. Still, it may serve as a proxy that makes banks prepare for potential losses in future. Second, the fact that measuring climate risk is proving difficult is no excuse for inaction. Where the principle of prudent valuation is central to internationally agreed accounting rules, financial policy should move towards a [precautionary approach](#) and no longer ignore the biggest risk mankind is facing this century.

**Banks' contribution to net zero must become transparent, mandatory and enforceable.** Global, industry-led alliances such as the Net-Zero Banking Alliance ([NZBA](#)) publicly boast of their commitment to move their lending and investment portfolios to net-zero emissions by 2050. But, despite those bold pledges, NZBA members [refuse](#) to set greenhouse-gas emission reduction targets and continue to [finance](#) fossil fuel investments instead. A powerful tool to make banks move beyond voluntary approaches is mandatory prudential [transition plans](#) where banks must outline specific targets and actions for how they intend to align their business with the goal of limiting global warming to 1.5°C. Within the ongoing review of EU banking rules, the co-legislators are [backing](#) the inclusion of transition plans in the prudential supervisory process. The effectiveness of this instrument will depend on the powers finally granted to supervisors to enforce banks to align their business with the transition plans. If supervisors conclude that a bank's transition plan is flawed or incompatible with a sustainable transition, they must have the power to take supervisory measures such as imposing an additional capital requirement, restricting dividend payments, limiting or even prohibiting a certain business. Complementing a "one-for-one" capital requirement which addresses the risk of new fossil fuel financing, mandatory prudential transition plans would ensure that banks align their *existing* business with the needs of a sustainable economy.

**Poor energy efficiency of buildings constitutes a financial risk.** [Buildings](#) are the single largest energy consumer in Europe, using 40% of our energy, and creating 36% of our greenhouse gas emissions. Considering the importance of housing retrofits for delivering on the Green Deal, the European Commission proposed [new requirements](#) for building renovations. Within the revision of the Energy Performance of Buildings Directive (EPBD), [co-legislators](#) are discussing the introduction of mortgage portfolio standards that would require banks to increase the energy performance of buildings covered by their mortgages. Acknowledging the financial risk that poor energy performance of buildings constitutes for mortgage lenders, the ECB in an [Opinion](#) welcomes such mortgage portfolio standards and recommends making them increasingly stringent over time. By spelling out the pace and timeline of the sustainable transition in the buildings sector, this tool would provide banks with clear guidance for their mortgage credit business.

### 3.3 Ensure monetary policy does not contradict EU climate goals

Table 3: ECB actions to consider climate change in monetary policy

Measure	Application date
Tilt the asset portfolio towards green by using a tailored climate risk scoreboard for reinvestment decisions	1 Oct 2022
Consider climate change risks when reviewing haircuts applied to corporate bonds used as collateral	Dec 2022
Integrate climate considerations into the Eurosystem's inhouse credit ratings	End 2024
Limit the share of assets issued by entities with a high carbon footprint that can be pledged as collateral by counterparties when borrowing from the Eurosystem	End 2024
Accept only marketable assets and credit claims from companies and debtors that comply with the Corporate Sustainability Reporting Directive (CSRD) as collateral in Eurosystem credit operations	2026
Establish green targeted longer-term refinancing operations	Asap

Source: Own illustration. Colour code: What the ECB is already doing / What the ECB announced to do / What the ECB should do.

**Investments in green technologies are highly sensible to changes in the cost of capital.** Many green energy technologies are more capital intensive than fossil-based technologies as the former have relatively large upfront costs. While a gas-fired power plant may use its current revenues to pay for new fuel, the current revenues of a wind or solar project flow into debt service. [Simulations](#) suggest that doubling the cost of capital from 5% to 10% would raise the levelized cost of electricity (LCOE) of a gas-fired power plant by only 8%, but that of offshore wind would rise by 47%, for onshore wind and utility scale solar PV by 52-54% and for rooftop solar by 60% even.

**Tighter monetary policy may impact clean energy finance more than other parts of the economy.** Due to renewables' higher sensitivity to the cost of capital, they are more competitive when bank credit is cheap. For more than a decade, green investment enjoyed very low lending rates via an accommodative monetary policy. However, to counter the high inflation predominantly driven by the current energy crisis, the ECB has recently started to tighten monetary policy and has signalled this will continue until inflation expectations are back to normal. It put a [halt](#) to its asset purchase programme, [started](#) to raise interest rates for the first time in eleven years in July 2022, and began to [shrink its balance sheet](#) in March 2023. These tighter monetary policies hamper green investment disproportionately and may seriously slow down the green transition.

**The ECB is working on the consideration of climate change in its policies.** In 2021, the ECB adopted a new strategy including a [climate action plan](#). Therein, it acknowledges the impact of climate change on the stability of the financial system, the transmission of monetary policy and its own risk management. By reducing the need for expensive fossil fuel imports, the green transition has the [potential](#) to significantly lower energy prices and cut inflation. Considering climate change in its monetary policy may thus serve the ECB's [primary objective](#) of price stability. In addition, promoting green investment allows the ECB to fulfil also its [secondary objective](#) of support for general EU economic policies including a high level of protection for and improvement in the quality of the environment.

**Implementation of the ECB's climate action plan is slow.** The ECB in 2022 [adopted](#) the first concrete measures to implement its climate action plan. It decided to adjust corporate bond holdings in the Eurosystem's monetary policy portfolios and its collateral framework, to introduce climate-related disclosure requirements and to enhance its [risk management practices](#). However, as Table 3 above shows, the positive impact of these measures on the financing conditions of green investment will only be felt in several years' time. There are only two measures already in force and their effect is limited.

**Monetary policy's tailwind for green investment is only a mild breeze.** Since 1 October 2022, the ECB has been [tilting](#) its reinvestment asset purchases for maturing corporate bonds towards issuers with a better climate performance. However, the volume of corporate sector purchase programme (CSPP) reinvestments of redemptions [are expected](#) to total no more than €11bn for 2023 – tiny compared to the €344bn of [CSPP holdings](#) at the end of 2022. Greening the reinvestments of the €44bn of corporate bonds included in the pandemic emergency purchase programme ([PEPP](#)) will not add much to the overall picture. Even more disappointing, the ECB ignored the opportunity to include climate change considerations in the [haircuts](#) applied to corporate bonds used as collateral in its periodical review on [20 December 2022](#). Like the entire financial sector, the credit risk considerations of the ECB still suffer from what Mark Carney calls the [tragedy of the horizon](#) and fail to look beyond the immediate future.

**In the short-term, the ECB should extend the greening of its policies to refinancing operations.** Refinancing operations are a core monetary policy tool providing liquidity to credit institutions. Following the 2008 financial crisis, several central banks extended the maturity of their lending under these programs and offered reduced rates for bank refinancing of loans to particular segments of the economy. To promote investment in clean energy and energy efficiency and bring down energy prices, the ECB should consider introducing targeted longer-term refinancing operations (TLTROs) dedicated to the green transition.

**A preferential green lending facility is in line with the ECB's price stability mandate.** In its strategy review, the ECB [acknowledged](#) the benefits of green TLTROs as one option to integrate climate change into its monetary policy. It has not put it into practice so far, arguing that there was no proper definition of green credit, a lack of data collected by banks and that differentiated lending would harm monetary policy transmission. However, these concerns seem exaggerated. First, capital-intensive green investment is more sensitive to interest rate changes as we indicated above. A lower interest rate for sustainable investment would thus not undermine today's stricter monetary policy stance but level the impact of interest rate hikes on sustainable and non-sustainable investment. Second, climate change itself may lead to price volatility and thus endanger the future transmission of monetary policy. By supporting sustainable investment, green TLTROs mitigate climate change risks and thus serve price stability in the long term, whereas the ECB currently limits its primary mandate to the [medium term](#). Third, acting sector-specifically would not be a novelty in ECB history. In fact, it has operated [three series](#) of dual-rate TLTROs since 2014, incentivising bank lending to non-financial corporations and households for purposes other than housing. Introducing a green lending facility would continue the established practice of sector-specific lending but align it with the transition to a low-carbon economy serving both ECB primary and secondary objectives.

**By introducing green TLTROs, the ECB would fulfil its secondary objective.** Without prejudice to the primary goal of safeguarding price stability, a [secondary objective](#) of the ECB is to support the general economic policies in the EU and, more specifically, its climate neutrality ambitions. Frank Elderson, Member of the ECB's Executive Board and Vice-Chair

of its Supervisory Board, [stated](#) that the central bank is not directly subject to the [European Climate law](#) that requires all EU institutions to take the necessary measures to meet the legally binding target of net zero greenhouse gas emissions by 2050. Still, he acknowledges that the climate law obliges the ECB to support the climate neutrality dimension of measures falling within its competences. Put differently: By discarding green TLTROs that do not contradict its price stability mandate, the ECB fails to deliver on its secondary objective.

**When it comes to the concrete implementation of green TLTROs, the ECB should take a pragmatic approach and not wait for the perfect solution.** For the time being, the identification of green lending remains the biggest challenge for a green lending facility. The Bank of Japan ([BoJ](#)) and the People's Bank of China ([PBoC](#)) have already introduced green lending schemes but let banks decide on eligible green activities. The ECB should take a different route and build on existing sustainability definitions to minimise greenwashing risks. While the EU green taxonomy does not cover yet all economic activities and a [green loan definition](#) will not be available before the end of 2023, detailed screening criteria are already available for two of the six environmental objectives of the taxonomy. In addition, since June 2022, EBA [guidelines](#) require banks to provide a list of the activities they consider eligible for environmentally sustainable lending or provide a reference to relevant existing standards such as the taxonomy. Taking advantage of this important pre-work, the ECB should launch a first green TLTRO covering important but uncontroversial sectors such as renewable energy and energy-efficient housing where [energy performance data](#) is already available. Once banks start to systemically collect the necessary information for [disclosing ESG risks](#) in the form of the green asset ratio (GAR) and the banking book taxonomy alignment ratio (BTAR), the ECB could make adjustments to the scheme and launch a second green TLTRO based on the composition of banks' entire loan portfolio.

#### 4 Conclusion

**For now, banks matter more for Europe's green transition than financial markets.** Policymakers and the financial sector have teamed up behind the idea that capital markets could provide the necessary funding for the European Green Deal. While listed companies do indeed issue shares and bonds to finance the greening of their business, the largest part of private investment in the European clean energy economy is funded by banks. Considering the slow progress of financial market integration in Europe and the resistance of governments to harmonising company, tax and insolvency laws, it seems reasonable to conclude that banks will remain the most important funding source of the European economy in the foreseeable future. This paper therefore puts forward proposals to align the provision of bank credit with Europe's climate goals.

**Transparency alone will not suffice.** In the greening of its banking system, Europe does not start from scratch. The EU has established mandatory sustainability disclosures that provide information on the greenness of economic activities and aid the financial sector in handling climate risks. However, improving the availability of harmonised climate risk data is a necessary but not sufficient condition for greening the financial system. To deliver on the European Green Deal, the additional transparency should translate into binding measures that stop banks from financing high-carbon projects that will lose the larger part of their value in the course of the green transition. This is imperative to finance a clean energy economy and preserve financial stability.

**Greening the banking system has its limits.** First, focusing climate risk policy intervention on bank lending alone will drive fossil fuel assets into the shadow banking sector that is not subject to similar disclosure and capital requirements. With the aim of closing the

door to [regulatory arbitrage](#), pension funds, insurance companies, asset managers and other non-banks should also become subject to climate risk requirements. And second, the sustainable transformation of the European economy will not succeed without additional public investment. The state has a crucial role to play, ranging from encouraging private investment to directly or indirectly financing priority areas such as electricity grids and railway upgrades to funding the development of [high-risk technologies](#). Going forward, it will be important to ensure public support is targeted, available across all of Europe and does not reward private actors with risk-free returns.

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