Mariantonietta Intonti

SUSTAINABLE FINANCIAL SYSTEM

The ESG Banking and Finance, between Current Challenges and Future Prospects

FrancoAngeli

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To my mother,
my exuberant and passionate past,
who left while I was writing.

To my daughter,
my smiling and enthusiastic future,
who is the greatest gift I have ever received.

To my husband,
my solid and brilliant present,
with whom I live each day
between the serious and the facetious.

And finally…
to the Life.

Table of contents

Introduction

"We must exclude unsustainable companies from investments".
Pope Francis, October 12, 2020
TED Countdown, a global initiative to
accelerate solutions to the climate crisis

The book follows the theoretical approach of the Economics of Financial Intermediaries scientific sector, which sees the financial system as a complex infrastructure made up of intermediaries and financial markets, financial instruments and a system of rules[1]. The sustainable financial system sees these components move in compliance with the principles of sustainability, expressed in the three areas summarized by the acronym ESG, Environmental, Social and governance. In this way, sustainable financial intermediaries operate in compliance with and in favor of the environment, the rights of stakeholders and according to good governance and organization practices. Sustainable financial instruments allow financial resources to be moved by pursuing ESG objectives, and regulation requires compliance with the principles of sustainability in financial intermediation, in the structure of the instruments and in the information documents.

The book contains a valuable work of knowledge systematization on the topic of sustainable banking and finance, which includes both contributions to research and tools useful for financial education about the managing of financial resources for the care of the "common home" and collective wellbeing.

This work is the result of 24 years of research and teaching on Sustainable Finance and Economics of financial intermediaries. It is also the result of a passion that began in Deutsche Bank, when I was given the book "The

[1] P. Bongini, M. L. Di Battista, L. Nieri, A. Patarnello, *Il sistema finanziario. Funzioni, istituzioni, strumenti e servizi*, il Mulino, Bologna, 2004; G. Forestieri, P. Mottura, *Il sistema finanziario*, Egea, Milano, 2017.

Banker of the Poor People" by Muhammad Yunus[2]. I was 26 years old and the story of the microcredit and the Grameen Bank, told in that book, moved me greatly and marked the development of my work and my subsequent academic career.

[2] Y. Muhammad, *The Banker of the Poor People*, Feltrinelli, Milano, 1998. Title of the original work: Y. Muhammad, *Verse un monde sans pauvreté*, Editions Jean-Claude Lattés, 1997.

1. Sustainable Financial System: an Overview

1.1. Sustainable Finance and the European Commission's Action Plan

Based on the literature and the operational practice, it can be stated that the expression "sustainable finance" has two interconnected definitions.

It refers to a unique form of financial intermediation where monetary resources are exchanged between sustainable surplus parties (such as savers/investors) and sustainable deficit parties (like enterprises). This enables the providers of financial resources to allocate them to recipients that pursue ESG (environmental, social, and good governance) worthy business and financing goals. In this way, sustainable finance facilitates the achievement of the United Nations' 17 Sustainable Development Goals, as outlined in the 2015 Agenda 2030 document[1].

On the other hand, the expression "sustainable finance" identifies a specific sustainable financial system where specialized operators act, including ethical or sustainable banks, ethical or sustainable asset management companies, sustainable investment companies, microcredit and microfinance operators, sustainable insurance companies. These operators use specific financial instruments, classified as ethical or sustainable, and involve investors driven by the goal of allocating their resources to economic operators

[1] United Nations, *Agenda 2030*, 2015; U. Biggeri, G. Ferri, F. Ielasi, *Finanza etica*, il Mulino, Bologna, 2021; A. Del Giudice, *La finanza sostenibile. Strategie, mercato e investitori istituzionali*, Giappichelli, Torino, 2022; M. Intonti, Il microcredito: una speciale forma tecnica di finanziamento, *Quaderni di Minerva Bancaria*, n. 4/2017; G. Birindelli, E. Bruno, A. Tarabella, *La business ethics e la comunicazione esterna di impresa*, FrancoAngeli, Milano, 2002.

who ensure satisfactory use from environmental, social, and proper governance perspectives, not just economically and financially.

As is evident, this allocation of financial resources is made possible by the presence, within the sustainable financial system, of socially responsible enterprises and operators who are concerned with the impact of their activities on the surrounding community and stakeholders, in line with the definition of social responsibility provided by the European Commission[2].

Certainly, the global financial crisis is at the origin of sustainable finance. The crisis that originated in 2008 due to the collapse of the Leman Brothers bank has had negative consequences for the economic and financial system. However, it has also provided momentum to the principles underlying ethical and sustainable finance. This crisis has shed light on the detrimental aspects of speculative finance, which prioritizes private interests over the well-being of society as a whole. It has also exposed the significant disparities between various social classes and between impoverished and affluent nations. In contrast, sustainable finance emphasizes the responsible allocation of financial resources to enhance collective welfare.

Today, therefore, sustainable finance is a modern approach to financial intermediation that prioritizes the well-being of individuals over profit. It aligns with the principles of civil[3] economy and the social doctrine of the Church: "… The economy must serve man, not man to the economy…"[4]. Pope Francis has consistently emphasized the significance of achieving fairer financial systems, urging governments to prioritize a stronger dedication to an "international framework that promotes investments with a high social impact" and highlighting how, even within the Roman Curia, "innovative forms of investment are being studied that can benefit local communities and the surrounding environment, as well as a fair return"[5].

[2] M. Intonti, Il microcredito: una speciale forma tecnica di finanziamento, *Quaderni di Minerva Bancaria*, n. 4/2017; Pope Benedetto XVI, *Encyclical Caritas in veritate,* 2009; Pope Francis, *Conference promoted by the Pontifical Council for Justice and Peace on the theme "Investing for the poor"*, private hearing, 2014; Pope Francis, *Apostolic Exhortation Laudate Deum*, 4 Oct. 2023; Pope Francis, *Encyclical Laudato Sì*, 2015; L. Becchetti, *Il microcredito. Una nuova frontiera per l'economia*, il Mulino, Bologna, 2006; S. Lanza, M. Calcaterra, M. Perrini, *Etica, finanza e valore di impresa*, Egea, Milano, 2001; M. Intonti, *Valore economico e comportamento etico nelle imprese bancarie*, Cacucci, Bari, 2004.

[3] L. Bruni, S. Zamagni, *Economia civile. Efficienza, equità, felicità pubblica*, il Mulino, Bologna, 2004.

[4] Pope Benedetto XVI, *Encyclical Caritas in veritate*, 2009.

[5] Pope Francis, *Conference promoted by the Pontifical Council for Justice and Peace on the theme "Investing for the poor"*, private hearing, 2014.

The commitment urged by the Pontiff has today been embodied in the European Union's Action Plan: Financing Sustainable Growth document, the culmination of an unfinished journey on spreading the principles of sustainable finance on our continent.

In order to raise public awareness on the issues of sustainable finance, in September 2015, the United Nations 2030 Agenda was followed by the European Union starting process of including sustainability issues in the financial sector. This path, mainly relating to environmental issues, began with the signing, in December 2015, of the Paris Agreement[6], the first step towards the diffusion of a growth and development model oriented towards environmental protection. Subsequently, in December 2016, the European Commission established the High-Level Expert Group on Sustainable Finance (HLEG) which, in 2018, published the report "Financing a sustainable European Economy", aimed at launching, in March 2018, the "Action Plan to finance sustainable growth", with the goal of increasing investments in sustainable projects and integrating environmental, social and governance criteria into risk management by financial operators.

The Plan identifies all the activities to be implemented with the support and involvement of financial market operators, including investors, intermediaries and managers, in order to achieve the three objectives suggested by the HLEG, namely:

1. steer capital flows towards sustainable investments;
2. limit the financial impact of environmental and social risks: an increase in world temperature exceeding the limits set by the Paris Agreement could generate destabilizing effects on the European economy and financial system, linked to events triggered by climate change. This could lead to greater exposure of banks to losses, due to the difficulties of client companies exposed to climate change and therefore also subject to climate risk;
3. ensure the transparency of market operators: greater disclosure transparency on sustainability issues could allow investors to compare the ESG performance of companies and make informed decisions on their investments.

[6] European Union, *Paris Agreement, ratification*, 2016.

Fig. 1 - From the 2030 Agenda to the EC Action Plan

Source: European Commission, 2018.

To achieve the three objectives, the Action Plan: Financing Sustainable Growth includes ten actions (Fig. 2).

Fig. 2 - Objectives and actions of the Action Plan on sustainable finance

Objective	Description	Planned actions
1) Reorienting of capital flows towards a more sustainable economy	Since the current level of investment is not enough to support a sustainable economic system from a environmental and social perspective, huge further investments are necessary	1. Establish a unified classification system of sustainable activities
		2. Create standards and brands for sustainable financial products
		3. Promote investments in sustainable projects
		4. Integrate sustainability into financial advice
		5. Develop sustainability benchmarks
2) Integrating sustainability into risk management	In order to limit the financial impact of environmental and social risks, the financial decision process should include ESG considerations	6. Integrate sustainability into ratings and market research at best
		7. Clarify the sustainability obligations of institutional investors and asset managers
		8. Integrate sustainability in the prudential requirements of banks and insurance companies
3) Promoting transparency and encourage a long-term vision of economic and financial activities	In order to make informed decisions, a greater transparency is needed to allow investors to compare sustainability performances of investee companies. Besides, since sustainable investments require a long-term vision, short-termism should be limited	9. Strengthen sustainability communication and accounting regulation
		10. Promote sustainable corporate governance and mitigate the short-term vision in the capital markets

Source: Elaboration on European Commission, Action Plan for financing sustainable growth, 2018.

The first objective, "Reorientering of capital flows towards a more sustainable economy", involves five planned actions.

1. Establishing a unified classification system for sustainable activities across the EU. The shift of capital flows towards a sustainable economy can only be achieved by clearly defining the category of activities that can be defined as "sustainable". For this reason,

the Action Plan has among its primary goals the creation of a unified EU classification system, also defined as the "Taxonomy Regulation"[7]. The taxonomy consists in a classification that helps investors to easily identify sustainable products, thus reducing the risk of "green washing"[8] operations, and it thus provides information on sustainable sectors through criteria, thresholds and parameters that will support investment choices. The taxonomy was initially focused on sustainable activities from an environmental perspective, while only recently has the issue of social sustainability been addressed.

2. Creating standards and labels for sustainable financial products, that can identify Environmental, Social and Governance (hence ESG) financial instruments, to ensure investor protection and transparency in the sustainable finance market. The definition process has already led to the creation of an EU standard for green bonds, the bonds issued to support projects that have a positive impact on the environment, such as those relating to energy efficiency or the production of energy from renewable and clean sources etc…
3. Promoting investments in sustainable projects: in this context, the goal is to mobilize private capital towards sustainable projects, highlighting the importance of the appropriate use of financial resources as a strategic lever for achieving the ecological transition.
4. Integrating sustainability into financial advice: financial advisors are also called upon to ensure reorientation towards sustainable investments, including sustainability in their advisory activity, identifying customer preferences in the ESG scope and suggesting a range of suitable products to meet their needs.
5. Developing benchmarks on sustainability: in addition to providing new financial instruments with sustainability characteristics, it is important to create market indices that comply with ESG criteria, which differ from traditional benchmarks and allow to specifically assess the performances of sustainable investments. For this reason,

[7] European Parliament and Council, *Taxonomy Regulation 2020/852 on the establishment of a framework that favors sustainable investments and amending regulation*, 18 June 2020.

[8] Phenomenon which consists in defining financial products, practices or company policies as "green" even if they are not, or only in part, in order to attract the market. This practice is adopted by companies that are interested in acquiring a "green" reputation, without adopting an effective modus operandi that differentiates them from traditional companies.

the Action Plan has provided for new ESG benchmarks to be created, based on sustainability objectives.

The second objective of the Action Plan, "Integrating sustainability into risk management", includes three actions:

1. Integrating sustainability into ratings and market research in the best possible way: in the face of such a radical change, market research providers and rating agencies need to adopt different strategies to best assess the ESG performance of companies and their resulting ability to manage the risks associated with sustainability. In this context, ESMA[9] is called upon to intervene, pushing credit rating agencies to integrate sustainability and long-term risks in the assessments made for rating issuers.
2. Clarifying the obligations of institutional investors and fund managers: in compliance with the "fiduciary obligation", the EU requires institutional investors and fund managers to act in the individual investors' best interests. At the same time, however, no obligation is explicitly stated regarding the inclusion of ESG factors and sustainability risks in the investment process. In this context, the recent disclosure regulation (Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector) was issued.
3. Integrating sustainability into the prudential requirements of banks and insurance companies: the action intends to induce supervisory authorities to consider sustainability risks in defining the risk profile and determining the capital requirements of banks and insurance companies, in order to encourage the growth of ESG financing and investments. In this respect, Directive 2019/2034 and Regulation 2019/2033 have been published, amending the CRD IV Directive and the CRR Regulation on capital requirements in banks. The Directive requests that EBA assess the inclusion of environmental, social and governance risks into the supervisory activity of the competent Authorities and to prepare a report on the introduction of technical criteria for ESG exposures as part of the review and evaluation of the supervisory requirements; in the Regulation, on the other hand, EBA is given a mandate to develop the Technical Stand-

[9] European Securities and Markets Authority, ESMA, is the authority, based in Paris, responsible for the supervision of securities and their markets, at European level.

ards for the Disclosure of ESG risks, physical risks and transition risks, by large listed banks and to assess whether a prudential treatment dedicated to ESG exposures is justified. The Commission will then consider whether it is possible to recalibrate the banks' capital requirements for sustainable investments[10].

Lastly, there are the two actions relating to the third objective, namely that of "promoting transparency and encouraging a long-term vision of economic and financial activities".

1. Strengthening the communication on sustainability and accounting regulation: according to Directive 2014/95/EU on non-financial reporting (NFR), "large companies that are entities of public interest […] include in the management report a non-financial statement ("DNF", Dichiarazione Non Finanziaria in Italian) containing at least information on environmental, social, personnel aspects, and on respect for human rights […]". Such document constitutes a first intervention carried out at European level in order to induce institutions to disclose relevant information on the main environmental, social, governance aspects and on ESG risk management, achieving a good compromise between flexibility and standardization of the information to support investors' investment choices.
2. Promoting sustainable corporate governance and mitigating short-termism in the capital markets: this action originates from the objectives that company managers set themselves, often of an exclusively economic-financial and short-term type, neglecting opportunities and risks resulting from considerations related to environmental and social sustainability, which would instead guarantee a perspective of value creation in the long term.

Regarding action 8, "Integrate sustainability in the prudential requirements", it is important to highlight how this action involves the aim to include risks associated with climate and other environmental factors in the risk management policies of financial intermediaries and represents a highly relevant element for the purposes of the green transition. The goal, however, should be to take ESG factors into account in determining the capital requirements for sustainable loans, in cases where this is justified from expectations of concrete lower risk, so that the effectiveness and consistency of financial stability is safeguarded. It is clear, as stated in the Principles for Responsible Investment, that any recalibration of capital re-

[10] Consob, *The Action Plan for Sustainable Finance*, Consob.it.

quirements implemented to include these elements should be based on the EU taxonomy regarding sustainable activities[11].

In our country, the Bank of Italy, in following the development of the works done by the European Commission within the scope of its competences, has focused on the most appropriate ways for intermediaries to incorporate climate risks (composed of physical risk and transition risk) in particular in risk management policies, as well as in prudential assessments. In this regard, there is broad consensus, even among other regulators, on the concept that the risks deriving from ESG factors do not represent a random category in their own right but rather that they affect traditional risk categories (credit, market, operational). For this reason, intermediaries will have to organize appropriate governance, organizational and internal control systems, and they will also need to develop appropriate assessments, embracing a long-term time horizon, to determine the impact of climatic and environmental risks on their portfolios and on their business strategies. The assessment partly requires the use of new methodologies, data and forecasting scenarios, that are thus suitable for evaluating losses resulting from high impact and low frequency events, linked particularly to the occurrence of extreme climate events. In particular, for physical risk, the analysis must allow for the calculation of the vulnerability indicators of assets with respect to climatic factors, for example taking into account the location of the investments; for transition risk, on the other hand, it will have to determine the impact of stricter rules on energy efficiency on the value of real estate as collateral for mortgages, to name just a few among the potential implications of such risk[12].

Furthermore, one needs to consider the role of banks and insurance companies both regarding the orientation of capital flows and regarding the defense of the stability of the economic system as a whole, and the high exposure of the banking and insurance system to risks related to climate change. Therefore, it is necessary, following the Commission's indications, to incorporate sustainability considerations into prudential requirements, to avoid bank assets are excessively skewed towards activities with high physical or transitional risks[13].

[11] PRI, Principles for Responsible Investment, *Action 8: Incorporating sustainability in prudential requirements*, 2018.

[12] L. F. Signorini, *Rischi climatici e regolamentazione prudenziale*, Convegno Sviluppo sostenibile, finanza e rischio climatico, 2019.

[13] Aifirm, Italian Association of Financial Industry Risk Managers, *Position Paper n. 20*, 2020.

1.2. EU Taxonomy for Sustainable Activities

Within the framework of the Action Plan, green and social taxonomies foreseen by Action 1 are very important classification systems that play a substantial role in sustainable finance.

The EU "green taxonomy" determines which economic activities are environmentally sustainable. The Taxonomy Regulation was published in the Official Journal of the European Union on 22 June 2020, entered into force on 12 July 2020 and covers six environmental objectives: climate change mitigation, climate change adaptation, sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control, and protection and restoration of biodiversity and ecosystems. For an economic activity to be considered environmentally sustainable under the taxonomy, in addition to the six environmental objectives, the EU taxonomy has established four requirements that must be met by economic activities to be "taxonomy oriented". These include: making a substantial contribution to at least one environmental objective, doing no significant harm to any other environmental objective[14], complying with minimum social safeguards, and complying with the technical screening criteria.

Recently, the European Union (EU) has been actively working on developing a social taxonomy to complement its environmental taxonomy as part of its sustainable finance agenda[15]. The EU social taxonomy aims to establish a common framework for identifying economic activities that contribute positively to social objectives such as social inclusion, employment, and access to essential services. The EU intends to guide investors and businesses towards socially responsible practices by defining criteria and benchmarks for social sustainability. The social taxonomy is still being developed; currently, the proposed structure of the social taxonomy has three objectives, each of which addresses a different group of stakeholders:

1. Decent work (including for value-chain workers);
2. Adequate living standards and well-being for end-users;
3. Inclusive and sustainable communities and societies.

Each objective will have sub-objectives to ensure that specific aspects are addressed, such as health and safety, healthcare, housing, wages, non-discrimination, consumer health, and communities' livelihoods.

[14] This is known as the "Do Not Significant Harm" principle (DNSH).

[15] https://finance.ec.europa.eu/system/files/2022-08/220228-sustainable-finance-platform-finance-report-social-taxonomy_en.pdf.