SCHJØDT

The European Commission
Attn.: Executive Vice-President Frans Timmermans
Sent to: frans-timmermans-contact@ec.europa.eu

17 December 2019

Dear Sir,

NEW GREEN DEAL – PROPOSAL FOR IMPROVED BANK FINANCING OF CARBON EMISSION REDUCTION UNDER A MORE AMBITIOUS EMISSION TRADING SYSTEM

Introduction

Advokatfirmaet Schjødt AS is a pan-Scandinavian law firm with offices in Oslo, Stockholm and London. Referring to the recent and very welcome initiative from the European Community ("EU") on a New Green Deal, we take the liberty of presenting our proposal on how to stimulate bank financing of carbon emissions reduction across Europe and thus facilitate a more aggressive implementation of a high carbon tax.

Our initiative concerns the Emission Trading System ("ETS") for tradeable European Emission Allowances ("EUA"). In short, we propose (1) upgrading ETS to allow EUAs to serve as collateral security for bank lending supported by minimum prices for EUAs guaranteed at the EU level or by the EU/EEA member states, and (2) on this basis instituting more extensive permit requirements and aggressive future cuts in EUA permits in ETS Phase 4.

On the first point: under this approach, loans collateralized with EUAs would qualify as zero credit risk exposures within the capital adequacy rules for financial institutions and thus become highly attractive to the financing sector. We believe this is superior to current regulatory initiatives with similar purpose on "green factor" discounts in the prudential requirements both because it would be much more effective and because it would mitigate concerns regarding banking risk and financial stability.

In our opinion, our approach would not create significant economic risks on the EU or its member states if properly managed. Firstly, the guaranteed minimum price would contribute to market prices for EUAs above the guaranteed level. Secondly, the guarantee would be a mere bridge financing facility to be compensated by future mandatory EUA purchases and/or carbon tax payments from the remaining carbon emitters. The model is thus fully compatible with the polluter pay principle.

If, on the one hand, the EU provides carbon-emitting industries with this less costly mechanism for financing their carbon emission reductions, then, on the other hand, a further step will be warranted in the coming 4th phase of ETS—namely, the inclusion of all major sources of carbon emission in the carbon tax system and increased cuts in the EUA quotas. In other words, if the more attractive financing option discussed above were made available for transition projects on a large scale, it would help to meet not just the 43% emission reduction targets in the Paris Treaty/EU Financial Action Plan, but even the more ambitious New Green Deal target of 55% reduction by 2030.

Bank financing is a key driver for investments and business development in Europe. Consequently, new credit volumes to finance a transition of the industries would contribute substantially to further growth and prosperity in Europe. Ultimately, an ETS with bankable EUAs as proposed may serve as an even better prototype for global initiatives for carbon tax systems with tradeable emission quotas than the ETS system currently in place.

ETS in two paragraphs

As the world's first system for taxing carbon emissions, the EU Emission Trading System ("ETS") introduced a market-based incentive for reductions, with tradeable EUAs representing emission permits (tax credits) for main sectors of carbon emitters. A total cap of EUAs is set at the EU level and is to decline by 1,74% annually in the 4th phase of the program (2021-30) to meet the Paris target of 43% emission reduction.

Recent price increases have contributed to increased investments in renewable energy in Europe. These increases prove the general efficiency of ETS. The positive effects would likely multiply if the Commission were to implement our proposed changes, as ETS will fit nicely into the regulatory framework for financial institutions under the Capital Requirements Regulation.[1]

"Green factors" - CRR 501c

Acknowledging bank financing as key to transitioning to a carbon-neutral environment, European financial regulators and policy makers contemplate changes to the capital adequacy requirements on financial institutions. The CRR specifies the level of equity capital that finance institutions must hold in order to grant credit. A key pillar is the risk-weighted capital requirement. This incentivises banks to provide loans with relatively lower risk weights. Because of this, banks prefer to finance mortgage loans, government bonds, and inter-bank loans with low risk-weights. Banks generally have lesser appetite for loans to commercial enterprises, which have lesser financing options and ultimately must pay higher interest, reflecting the banks' need for 2-5 times more equity capital to support loans to this sector.

[1] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms.

Placing this burden on European enterprises ultimately discourages enterprises from investing in transitioning to greener power plants, carbon-capturing tools, electricity-powered vehicles/planes etc., because new assets must be financed by loans at higher interest rates (or by equity, which has a high demand on return on capital). We believe the transition is likely to accelerate if loan financing is available at a lower price—i.e., if the EU removes a burden to borrowing money and thus makes these projects more profitable.

The new CRR 501c (yet to be implemented) is intended to stimulate green lending by providing a legal basis for the Commission to introduce risk-weight discounts on green loans (the "green factor"). There are, however, opposition voices to the green factor initiative, as the key policy in CRR is to address credit risk in banking to secure financial stability in Europe. A discount in the capital requirement not reflecting lower risk on green exposures may jeopardize this policy. Against this background, EBA is instructed in CRR 501c to consult with the ESRB and carefully assess if a "dedicated prudential treatment of exposures related to assets or activities associated substantially with environmental and/or social objectives would be justified", and then submit a report to the European Parliament, to the Council, and to the Commission by 28 June 2025.

Meanwhile the stimulus provided by CRR is "stacked against" banks offering green commercial loans at favourable prices. This forms the background for our proposal, since we strongly believe that the transition of the European (and world) economy into a carbon neutral environment would significantly benefit from increased bank financing and that the ETS system, with some upgrading, may be beneficial to this purpose.

<u>The CMU financial challenge and the New Green Deal</u>

EU Capital Market Union (CMU) plan has indicated annual investment needs at circa EUR 180 billion to meet the 2030 EU carbon target. An acceleration of the Paris targets (43% reduction) to the targets in the New Green Deal (55% reduction) will presumably increase the amount of financing needed.

To accelerate carbon reductions, major investments are needed in many sectors, including industries well suited for bank-loan financing such as transport (including airplanes), the process industries, agriculture, and the energy sector. These sectors however also face financial and operational risks in the transition to a carbon neutral environment. Here we believe the concept of "bankable EUAs" may be an important tool to incentivise bank lending for a number of transition projects including major infrastructure assets, new energy plants, energy-efficient and carbon neutral transport vehicles as well as carbon capturing and/or emission-reducing technology and -solutions.

Properly calibrated, bankable EUAs with a price guarantee will help the "early birds" in many industries to secure bank financing of transition at lower finance costs, while not jeopardizing the prudential requirements in the banking sector and financial stability in Europe, as the green factor discount may do. Nor will our proposed model provide significant economic risk to the EU or its member states as we perceive it, as we will further explain below.

Our proposed changes to ETS

EUAs are defined as "financial instruments" in the European financial market acts MIFID II[2] and MAR[3] and are thus subjected to financial market rules. The definition of financial instruments in the Financial Collateral Directive[4] is however yet to be aligned with the definition in MIFID II and MAR, and consequently EUAs are not recognized as eligible financial collateral cross Europe. Such a change in definition would imply that EUAs may serve as collateral security for loans and reduce the risk-weight on green loan exposures under CRR all over the EU and EEA.

However, EUAs carry a certain political risk, in the sense that the market price is a function of the carbon tax level, EUA volumes made available to the industries and more generally the political will and stamina to reduce this volume in the future. Historically the EUA prices have been low (and still are, in our opinion) due to overflow of EUAs in the market. This suggests that the mere recognition of EUAs as a legal collateral object is probably not enough to stimulate bank lending on a large scale on favourable terms to borrowers.

To stimulate such lending, EU or the individual EU/EEA member states should introduce a guarantee in favour of financial institutions, bondholders, and other lenders financing emission reductions cross Europe. The guarantee should in practice amount to paying the stipulated minimum price against receiving collateral EUAs in return, in the event that a lender forecloses on EUA-collateralised loans and the sales price for the EUAs achievable in the market happens to be less than the minimum price. Bank loan secured by EUAs will then carry zero risk weight under the current CRR regime (similar to treasury bonds) within the collateral values covered by the state-backed minimum price guarantee.

If the above-described system were in place, this would warrant a more ambitious carbon tax scheme, and specifically a more demanding schedule for reduction in permit volumes in the next phase (2021 to 2030). That is, this more ambitious scheme would be justified because emitters would have access to less expensive debt financing. The emission polluters would then have the choice between financing their emission reductions now (at "treasury terms", to use market terminology) or to face a steep increase in the effective carbon tax in the near future.

The model is fully compatible with the polluter pay principle and will not entail a significant risk to the EU or the EU-member states offering the price guarantee, for the following reason: the EUAs received by the authorities upon a foreclosure of EUA-collateralised loans would (1) go into the stock of EUAs to be auctioned to carbon emitters in later rounds or alternatively (2) be cancelled and thus balanced by increase in the effective taxes payable on carbon emissions. Either way, the guarantee provided would just be bridge financing where the bill ultimately is to be footed by the late carbon emitters to pay significantly increased carbon taxes. In all likelihood, the late emitters will be oil and gas companies and other enterprises with significant fortunes and profits to their books, still profiting from the emission activities.

[2] Directive 2014/65/EU.
[3] Regulation 596/2016.
[4] Directive 2002/47/EC

The minimum price guarantee system for EUAs could also be time limited to e.g. 2020-2025 to boost early initiatives and reduce "tail end" state risk. That is, the EU can phase out the guarantee as EU and EEA enters a low-carbon environment with fewer major polluters remaining.

In our view, the political message would also be very important to incentivising a fast transition. While allowing collateralization would lead to an initial reduction in the cost for enterprises financing green initiatives, a high guaranteed value for the EUAs would serve as an important signal on the future tax level on carbon emissions, and thus stimulate the profitability of green projects *even more*. That is, it would make green transition more profitable by lifting the future market price on carbon emissions. Most importantly, an improved financing model where the EU offers emitters the option to finance their carbon reductions with a state guarantee may provide the basis for a more ambitious and predicable introduction of a European carbon tax by decreasing permit volumes, adding additional force to increasing market prices for emissions.

By providing immediate benefits to the "early bird" reducers ETS would offer an attractive prototype to other jurisdictions with carbon tax systems. Properly developed, this could stimulate bank financing of green business at a great and global scale.

The concept may be introduced under the current auction model of ETS to ensure polluter pay but with a certain twist to further incentivize emissions reductions: enterprises presenting a committed emission reduction plan to the auctioning authority may bid on their equity contribution to the implementation of such plan. One would expect their bid prices to be significantly higher if their bid price is no longer be a payable to the regulator. This would further stimulate the best transition projects and provide for substantially increased equity financing of transition initiatives all over the industries.

We have no doubt that the plan we have described in this letter would also contribute to further investments and growth in Europe, in line with ambition of the New Green Deal.

We would be delighted to have the opportunity to discuss the proposal more in detail with relevant members of your staff in Brussels.

Yours sincerely
ADVOKATFIRMAET SCHJØDT AS

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