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How can Slovenian banks embrace sustainable finance

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This article takes you through the geopolitical and strategic context for sustainable finance and highlights some trends in the development of sustainable finance globally and in Europe. It outlines a number of possibilities where Slovenian banks can adapt their business models to meet sustainability objectives and support Slovenia's green transition. Sustainable finance can become an important competitive advantage for some banks, especially those that are the first to recognise the new opportunities that already exist or will arise from upcoming regulatory and technology-driven changes in banking and capital markets.

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Introduction

This article takes you through the geopolitical and strategic context for sustainable finance and highlights some trends in the development of sustainable finance globally and in Europe. It outlines a number of possibilities where Slovenian banks can adapt their business models to meet sustainability objectives and support Slovenia's green transition. Sustainable finance can become an important competitive advantage for some banks, especially those that are the first to recognise the new opportunities that already exist or will arise from upcoming regulatory and technology-driven changes in banking and capital markets.

Sustainable finance

The term 'sustainable finance' is very widely used and there may be differences in definition between different users around the world. For the purposes of this article, the definition used is that of the European Commission (European Commission, 2023), which is as follows: "Sustainable finance refers to the process of taking environmental, social and governance (ESG) considerations into account when making investment decisions in the financial sector, leading to more long-term investments in sustainable economic activities and projects. Environmental considerations might include climate change mitigation and adaptation, as well as the environment more broadly, for instance the preservation of biodiversity, pollution prevention and the circular economy. Social considerations could refer to issues of inequality, inclusiveness, labour relations, investment in human capital and communities, as well as human rights issues. The governance of public and private institutions – including management structures, employee relations and executive remuneration – plays a fundamental role in ensuring the inclusion of social and environmental considerations in the decision-making process. In the EU's policy context, sustainable finance is understood as finance to support economic growth while reducing pressures on the environment and taking into account social and governance aspects. Sustainable finance also encompasses transparency when it comes to risks related to ESG factors that may have an impact on the financial system, and the mitigation of such risks through the appropriate governance of financial and corporate actors."

Strategic and geopolitical context

Many countries around the world have set ambitious sustainability targets to achieve net-zero emissions by 2050 (e.g. EU, US, Japan, Switzerland, UK, Australia, UAE, Canada), some a few years later, i.e. by 2060 (e.g. China, Russia, Saudi Arabia) and some by 2070 (e.g. India). Countries with longer timeframes or no commitments are usually less developed or have other strategic priorities. The European Union's (EU) commitment to reduce greenhouse gas emissions by 55% by 2030 puts Europe on a path to climate neutrality by 2050, potentially making Europe the world's first carbon-neutral continent. As an EU

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Member State, Slovenia has committed to the same targets as the EU.

There have been a number of recent studies on the level of investment required to meet the Paris Agreement targets on global warming and achieve net-zero emissions by 2050. According to a study by McKinsey, there is an estimated global investment gap of USD 275 trillion, meaning that current investment would need to increase substantially by USD 3.5 trillion from a level of USD 5.7 trillion per year to an average of around USD 9.2 trillion per year (approx. +61% more per annum).To close the investment gap, the private sector needs to effectively complement the public sector (Krishnan, M., Samandari, H., Woetzel, J., Smit, S., Pacthod, D., Pinner, D., Naucler, T., Tai, H., Farr, A., Wu, W., Imperato, D., 2022).

Climate investment is growing but is still well below what is needed to meet Europe's net-zero emissions target by 2050, according to the EIB's Climate Investment Report 2022-2023. The EIB report notes that meeting the EU's climate targets by 2030 will require investments of around EUR 1 trillion per year, some EUR 356 billion per year more than in the period 2010 to 2020. In addition, the EU will spend up to EUR 300 billion by 2030 to become independent of energy supplies from Russia. Increased uncertainties such as geopolitical risks, restrictive monetary policies, energy crisis, high inflation, expected economic slowdown, higher cost of capital in combination with higher debt levels may force EU member states to consolidate their finances by cutting public investment in the future. The report also notes that the green transition to succeed, much of the investment will need to come from private funds in addition to public funds. Sustainable finance, which has already developed significantly and grown in volume, will play a very important role in the transition (EIB Economics Department, 2023).

In Slovenia, the estimated investment gap between the investment potential and the investment needs identified in the National Energy and Climate Plan is somewhere between EUR 8.0 billion and EUR 8.7 billion, i.e. around 2.0% of GDP per year, according to a report by the Fiscal Council of the Republic of Slovenia (Brložnik, J., 2022). Similar to the global and EU context, closing Slovenia's investment gap will require an effective mix of public and private funds, as well as preparedness for contingencies. According to BlackRock, the recent energy crisis combined with the war in Ukraine is accelerating the transition to lower emissions in the long term. In Europe, the race for clean energy leadership among the superpowers is likely to accelerate and intensify in response to the Inflation Reduction Act (IRA), particularly in the industrial and technology sectors. The IRA, passed by the US Congress last summer, provides some USD 369 billion in grants, loans and tax credits for the deployment of renewable energy and clean technologies in the US, of which some USD 90 billion has already been approved. Earlier this year, the European Commission unveiled the Green Deal Industrial Plan (in addition to the existing The Green Plan from 2019) to boost the competitiveness of Europe's zero-carbon industries and support a rapid transition to climate neutrality. With the new measures (simplifying state aid, European Sovereignty Fund, etc.), the EU is widening the so-called subsidy race with the US and other advanced countries (Japan, the UK, China, etc.) for key technologies and allowing EU Member States to increase public spending. The risk of climate policy gridlock, in the context of developed economies failing to increase public investment or take action to achieve net-zero emission targets, is closely linked to other geopolitical risks, such as strategic competition between the US and China, and global technology decoupling (BlackRock Investment Institute, 2023).

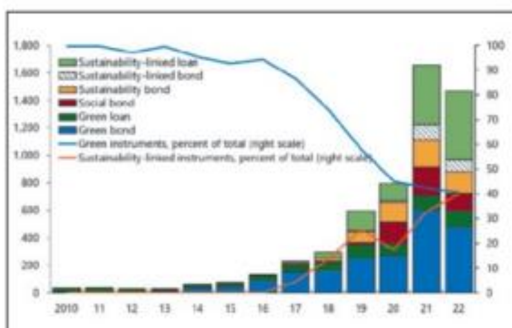
All these major strategic and geopolitical developments are bound to affect the future of sustainable finance in Europe and Slovenia.

Trends in sustainable debt and capital markets developments

Sustainable debt has grown exponentially in recent years, moving from the fringe to the mainstream. The high growth of sustainable debt turned downward in 2022 due to increased global uncertainties (war in Ukraine, energy crisis, high inflation, rising interest rates and cost of capital, etc.), with global outstanding sustainable debt falling by around -11% from USD 1.7 trillion to USD 1.5 trillion. Nevertheless, the growth of sustainable debt is expected to continue to accelerate, supported by strong geopolitical and strategic ambitions around the world. The trends show a strong momentum for sustainability-linked instruments, which have increased their share of the total sustainable debt from 33% to 40% in 2022.

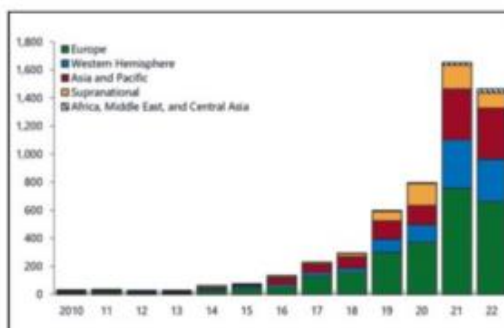
Advanced countries are the main borrowers with the most sustainable debt issuance in 2022, with Europe's share of total issuance remaining high and stable at 45% in 2022 (Gardes-Landolfini C., Gautam, D., Kemp, E., Xiao, Y. 2023). According to McKinsey, sustainable bond issuance currently accounts for about 12% of total global bond volume, with a similar share in the global syndicated loan market, where the volume of sustainability-linked loans accounts for about 13% of total global syndicated loan volume. In the sustainable debt market, it is interesting to note that sustainability-linked loans (SLLs) are growing much

Figure 1: Global Sustainable Debt Issuance by Instrument (in billions of US dollars)



Source: Bloomberg Finance L.P. and IMF staff calculations.

Figure 2: Global Sustainable Debt Issuance by Region (in billions of US dollars)

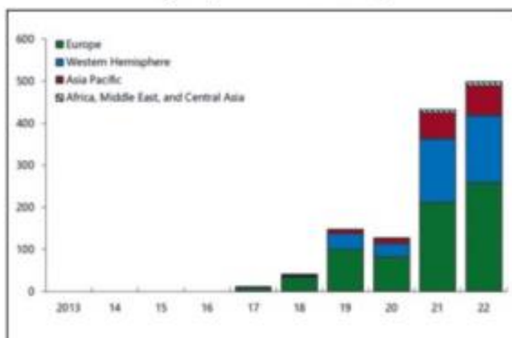


Source: Bloomberg Finance L.P. and IMF staff calculations.

faster than green bonds, which may be due to the dominance of bank financing globally. SLLs are performance-based instruments designed to be more flexible than "use of proceeds" instruments such as green bonds, which can only be used for specific, earmarked projects according to specific guidelines (EU taxonomy, ICMA principles, etc.). SLLs can mobilise significant capital for transition finance, although the evaluation of SLLs and their KPIs needs to be rigorous to ensure credibility and avoid greenwashing. According to the McKinsey study, banks are building innovative green businesses across all segments in products and services, as well as various advisory or trading platforms for their clients, enabling them to embark on a sustainability pathway. The figure below, prepared by McKinsey & Company, provides a comprehensive view of the new sustainable finance businesses in banking. (Cooke, M., Feldman, P., McCarthy, K., Runggatscher, M., Depin, C., 2022).

The AMFE report notes that Europe's global attractiveness as a place to invest in is falling further behind other countries. EU domestic market capitalisation of listed shares accounted for 10% of the world's total in 2022, a decline from 18% in 2000. The report shows that the progress of the EU CMU (Capital Markets Union) lags behind that of other advanced economies, particularly in terms of the widening equity gap between the EU and its global peers and the sluggish securitisation market, which continues to be a major drag on the EU financial system. In the EU, on average, about 9.4% of non-financial corporations use the capital markets for bond and equity financing. This is more than 10 percentage points less than in the US and the UK. Since the beginning of the pandemic, the share of corporate financing through the capital markets has been declining, largely due to the increase in the cost of capital and the high level of governments supporting the economies. The figure below shows that companies in Slovenia do not generally use the capital market to raise funds, indicating a strong reliance on bank financing compared to other European countries. Typical bond issuers in Slovenia, apart from the government, are usually banks and occasionally

Figure 3: Sustainability-linked Loan Issuance by Region (in billions of USD)



Source: Bloomberg Finance L.P. and IMF staff calculations.

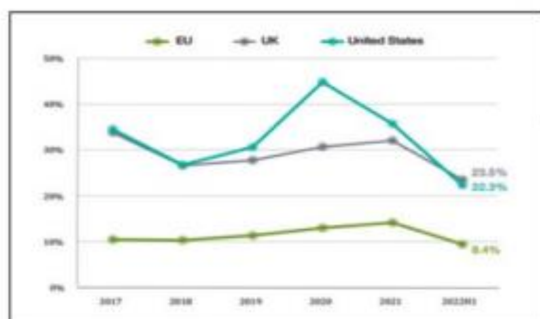
Figure 4: Banks' innovative green lines of businesses

Business type		Examples
Products and services Tailored offerings for sectors, technologies, or customer groups	Lending	**Retail banking:** Electric-vehicle (EV) loans, green mortgages **CIB[1]:** Sustainability-linked loans, green loans, securitized loans (eg, residential solar), supply chain financing
	Capital markets	**CIB:** Green bond issuance, equity issuance for cleantech companies, M&A advisory
	Investments	**Retail banking and CIB:** Green deposits **Wealth and asset management:** Climate technology funds, climate transition funds, decommissioning funds, blended finance funds
	Other innovative services	**Retail banking:** Car subscription, reverse leasing of rooftop solar **Wealth and asset management:** Proxy voting choice, climate-based security selection and portfolio modeling
Platforms Dedicated advisory or trading platforms for a wide range of customers	1-stop shop advisory platforms	**Retail banking:** EV education, purchasing, and financing resources for retail customers **CIB:** Energy-efficiency education and financing resources for customers that are small and medium-size enterprises
	Asset placement platform	**CIB:** Originate-to-distribute platforms for green assets (eg, renewable-infrastructure assets)
	Carbon markets	**All:** Carbon footprint tracking, carbon offset solutions

[1]Corporate and investment banking.

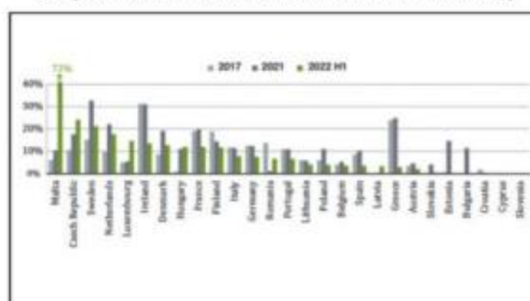
Source: McKinsey & Company

Figure 5: Market Finance Indicator (NFC equity and bond issuance as a % of total NFC annual financing)



Source: AFME, Capital Markets Union, Key Performance Indicators – Fifth Edition, November 2022

Figure 6: Market Finance Indicatorby country for bond and equity issuance by the Non-Financial Corporates (NFCs) as a % of total NFC financing



Source: AFME, Capital Markets Union, Key Performance Indicators – Fifth Edition, November 2022

larger companies, which also issue commercial paper from time to time. There are virtually no large initial or secondary public offerings on the capital markets.

To improve the functioning of capital markets in Europe, the European Commission has introduced a number of overhaul regulations in recent years, notably in the areas of securitisation and ELTIFs (European Long Term Investment Funds). The European Commission's CMU Action Plan proposes securitisation as a key tool for European capital markets to reduce the over-dependence on bank financing and improve access to capital markets for European borrowers. Securitisation is particularly valuable in freeing up bank balance sheets (RWA, capital optimisation, MREL requirements), facilitating financing for SMEs and mid-caps, and providing new investment opportunities for domestic and cross-border investors. According to AFME, green securitisation alone has huge potential and could exceed EUR 300 billion per year by 2030, including residential mortgages for energy-efficient properties, loans for green home renovations and financing for electric vehicles (AFME, 2022). Beyond green securitisation, the potential for securitisation more broadly is much greater, in particular because of the potential to achieve economies of scale by aggregating smaller illiquid loans into larger liquid packages, thus creating new attractive alternative investment opportunities for a broader investor base.

Synthetic securitisation has been used more commonly in Europe recently, and interestingly also by smaller banks in Central and Eastern Europe (CEE) and South-eastern Europe. A good recent example of a synthetic securitisation can be found in Romania, where Raiffeisen Bank S.A., in cooperation with the EIB Group, securitised a EUR 308 million non-retail loan portfolio, which remained on the bank's balance sheet and was split into senior, mezzanine and junior tranches. The risk of the mezzanine tranche was assumed by the EIF, while the risks of the senior and junior tranches were retained by the bank. The synthetic securitisation was used to optimise capital and MREL requirements, thereby increasing the bank's corporate lending capacity. Similarly, Raiffeisenbank Austria d.d., the Croatian subsidiary of Austria's Raiffeisen Bank International AG, undertook a EUR 366 million synthetic securitisation of its SME and corporate loan portfolio, with the EBRD assuming the risks of the mezzanine tranche through an unfunded protection guarantee. As in the previous example, the bank was able to reduce its RWA, and optimise capital and MREL requirements. The transaction is seen as a green securitisation as the new financing will support sustainability objectives.

The next major development in the capital markets is the revised ELTIFs regulation (ELTIF 2.0), which will be fully operational in early 2024 and is expected to boost investment in the EU economy as the new rules make it easier for asset managers to launch products for both institutional and retail investors. Key new benefits include easier access for retail investors, an expansion of eligible assets, the use of prudent levels of borrowing to increase investment potential and the ability to co-invest with other funds. The ability of ELTIFs to lend on a cross-border basis within the EU is a key feature of the ELTIF regulation. Over the next five years, the new ELTIF 2.0 could support an additional EUR 100 billion of financing for EU companies, growing exponentially from its current level of EUR 10 billion, according to the AFME report (AFME, 2022). The latest revision of ELTIF is part of the EU's wider Capital Markets Union initiative, which aims to strengthen EU capital markets and reduce reliance on bank funding. According to BlackRock, ELTIFs are virtually the only scalable vehicle capable of distributing private markets to retail investors across Europe's borders.

Banks around the world are accelerating investment in their

ESG capabilities, driven by strategic paths to zero emissions and new regulatory requirements on climate risk, reporting and disclosure. The most advanced and forward-thinking banks have already adapted their business models by enhancing their competitive advantage and creating a positive public image. The pace of change in sustainable debt, equity and alternative investment funds is exponential. Banks and other financial institutions, such as asset managers, insurance companies, infrastructure funds and other institutional investors, are becoming increasingly involved and committed to sustainable finance, increasing competition between participants both locally and internationally.

Sustainable finance possibilities for banks in Slovenia

The following section presents some possibilities and views on how Slovenian banks, together with some improvements in the capital market, could position themselves and integrate sustainable finance into their business models, thus contributing even more significantly to the green transition in Slovenia.

Hypothetically, Slovenian banks could be constrained by a lack of capital at some point during the green transition. Assuming a dysfunctional domestic capital market, this could lead to delays in the green transition or the need to involve more public funds. It is essential to prepare adequately for contingencies and to adapt as much as possible to the new realities created by global strategic and geopolitical drivers. The Slovenian banking system is considered relatively well consolidated and characterised by high household and corporate deposits compared to European banks. According to the Bank of Slovenia's Financial Stability Report, the liquidity coverage ratio at the level of the Slovenian banking system was around 290% in mid-2022, one of the highest in Europe. This implies a liquidity surplus above the regulatory requirement of around EUR 8.7 billion, about a quarter higher than before the start of the pandemic (Bank of Slovenia, 2022). Part of this surplus could gradually be transferred to the capital markets as attractive opportunities for households emerge over time. To stimulate the capital market, new investment opportunities need to be attractive in terms of return, risk and diversification benefits, and they need to be accessible quickly, easily and at low cost.

In the past, the strong liquidity position of banks in Slovenia and the steady growth of deposits have discouraged banks from actively issuing bonds, which has largely contributed to the low level of bond issuance and the absence of new forms of financing such as covered bonds and securitisation. In addition, the reliance of corporates on bank financing has been very high, probably due to favourable financial conditions and simpler and less costly procedures compared to capital market financing. Over the decades, this has resulted in a strong domestic banking system, which enjoys high public confidence, and an underdeveloped domestic capital market, especially compared to other European countries. It is also important to note that Europe lags far behind the most developed countries, such as the US and the UK, in terms of capital market development, and Slovenia is at an even greater disadvantage in this respect.

Assuming that deviations and anomalies revert to the mean in the long run, and in the context of strategic ambitions to strengthen the EU CMU (EC Capital Markets Action Plan) and the Slovenian capital market (Strategy for the Development of the Capital Market in Slovenia by 2030), financial resources in general, including those of Slovenian households, are likely to be allocated more optimally in the long run. Under this assumption, Slovenian banks will need to gradually increase the share of financial instruments on their balance sheets and, where appropriate, use them to optimise sustainability objectives with capital and MREL requirements. If this were to happen, Slovenian banks could actively use ESG-labelled financial instruments as part of their liabilities, such as green, social or sustainability senior preferred notes, senior non-preferred notes, AT1/T2 bonds, green covered bonds, green or brown securitisations and other innovative green instruments. Moreover, taking into account the fact that the Slovenian economy is highly dependent on bank financing and that the domestic capital market is rather underdeveloped, it can be expected that, at least in the initial phase, the share of green, social, sustainability and sustainability-linked loans as part of banks' assets will be the dominant financing compared to non-bank financing. Green, social, sustainability and sustainability-linked bond issuance in the non-bank sector is likely to remain limited to large corporates (at least until new distributed ledger technologies emerge).

Given the relatively small size of the Slovenian banking system and its capital market compared to its peers, it would be most practical to focus on a small number of solutions with the highest potential. The sustainable finance instruments with the highest potential for Slovenian banks could be green covered bonds (especially in the case of a structural decline in bank deposits over the next decade), green, brown or other types of securitisation (new supply of alternative investments with attractive risk/return profiles and diversification benefits) and investment funds (in particular ELTIFs, which are able to mobilise private funds on a larger scale). To accelerate the development of sustainable finance and gain a competitive advantage in this area,

Figure 7: Hypothetical new possibilities in the domestic banking system and the capital market

Slovenian banking system as at 31.12.2022 (m EUR)			Hypothetical new possibilities in banking system	Hypothetical new investment opportunities in capital market
Assets	**50,600**	**100%**		
Cash, CB, sight deposits at banks, Securities/Financial assets	19,204	38%	<--- green repos; green, social, sustainability securities / financial assets	Green and / or brown securitisation ---> investor universe: insurance companies, pension funds, asset managers, commercial banks, etc.
Loans to non-banking sector	27,538	54%	<--- green and/ or brown securitisation (originate-to-distribute model, synthetic or true sale) <---sustainability-linked loans, green, social loans, etc.	
Residual	3,858	8%		ELTIFs (max. 20% in securitisation, other exposures to infrastructure, sustainable bonds, real estate, alternative investment funds, etc.) ---> investor universe: professional and retail investors
Equity and liabilities	**50,600**	**100%**		
Liabilities to non-banking sector (deposits by NBS)	39,756	79%	<--- green deposits	
Debt securities	2,066	4%	<--- sustainable debt securities (e.g. commercial papers, covered bonds, SP, SNP, T2, AT1)	Distributed Ledder Technology - issuance, trading and settlement of tokenised financial instruments of SMEs and MidCaps ---> investor universe: professional and retail investors
Shareholder equity	5,151	10%		
Residual	3,627	7%		

banks and capital market participants need to use modern automation and artificial intelligence means to provide their clients with attractive investment or financing opportunities, not only in terms of risk/reward/diversification benefits, but also in terms of time and customer experience.

The figure below shows the structure of the Slovenian banking system and hypothetical possibilities in the area of sustainable finance for domestic banks in relation to the domestic capital market. Banks have a wide range of sustainable finance instruments at their disposal that they could use in the future, and they can also play a greater role than in the past in the development of the capital market.

Figure 7: Hypothetical new possibilities in the domestic banking system and the capital market

Finally, securitisation and ELTIFs deserve further consideration. Surprisingly, European banks currently make little use of securitisation and the use of ELTIFs is currently insignificant compared to their potential use as a means of efficiently allocating financial resources on a larger scale to support the green transition. In Slovenia, securitisation and ELTIFs are perhaps even more relevant because the relatively small size of individual transactions (loans, funding, investments) makes it almost impossible to achieve high efficiency in terms of liquidity, costs, profitability, and overall attractiveness to investors. Securitisation and ELTIFs could open the doors to new funding and financing opportunities for Slovenian banks and new investment opportunities for a wider range of investors by aggregating smaller tickets and different assets into larger pools with enhanced characteristics. Investors would benefit by participating directly or indirectly in loans through securitisation or ELTIFs, while banks would optimise their RWA and capital after selling their loans or transferring risks and gain capacity for re-lending to new projects. As the green transition in Slovenia requires the mobilisation of a significant share of private funds, securitisation (green and/or brown) and ELTIFs have the potential to play an important role.

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