How to communicate with banks and other financial intermediaries and present your sustainable and circular business project?

(Integrating Circular-related Risks into Banks' Capital Requirements)

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Current situation (1)

Current risk assessment methodologies are insufficiently developed for circular/ sustainable businesses/projects.

1. For the linear industry, they do not always identify the risks of remaining in the linear model (e.g. climate, societal, regulatory, tax, etc.).

2. Existing models insufficiently capture the specific financial profile of circular business models (e.g. asset ownership, cash flow dynamics, depreciation) and fail to value the benefits/risk mitigants of circularity.

Current situation (2)

Traditionally, externalities have been largely excluded from company's risk profiles and the measurements of corporate value or income statements.

1. This means that investors and companies have not been fully rewarded for the positive environmental or societal impacts they created through externalities, like creating jobs, using proven net-positive circular products or providing education and healthcare to workers or communities.

2. Conversely, investors and companies have also not been penalised for negative societal impacts, like generating or incinerating waste, depletion of scarce resources, noise and air pollution, or degrading ecosystems.

Current situation (3)

Circularity-related risks can potentially endanger the stability of the financial sector and they are only marginally addressed by Basel capital requirements.

1. Basel Agreement gives a more rigorous prudential treatment to long-term loans. This characteristic can then negatively impact the lending to circular projects which are by nature mid to long-term projects.

2. The Basel Agreement can be adverse to circular financing!

Circular risks and linear risks

Circular risk	Linear risk
Shift of mindset needed to see (used) products as valuable sets of modules and/or materials instead of waste.	Dependency on virgin resources (risk of supply chain disruption).
Required initial investment can cause deterioration in short-term margins.	Exposure to resource price volatility.
Balance of short-term margin versus long-term stability.	Increasing environmental legislation.
Market demand for the offered products: customers and companies are currently used to owning products.	Growing population and increasing financial wealth.
Dependency on supply chain collaboration.	Effects of climate change.
Unknown residual value of many products, due to small market of circular output companies (i.e. companies that upcycle, re-use, remanufacture or refurbish).	Demand for environmentally sound products.
Supply chain lock-in risk.	Businesses/products that become obsolete by holding onto old linear business practices (stranded assets).

Source: Money makes the world go round (and will it help to make the economy circular as well?); Working Group FINANCE, March 2016, The Netherlands, available through Ellen MacArthur Foundation: https://www.ellenmacarthurfoundation.org/assets/downloads/ce100/FinanCE.pdf, page 74.

Recomendation for coroprates

Clearly present risks associated with your „circular project“:

1. Emphasizing how you intend to reduce linear risks and manage circular risks

2. Showing how your project fits into the sustainability targets of bank (doing good bank‘s policies)

3. Increase the financeability of your circular business model by cash flow optimisation - circular models often create a longer lasting financial relation.

Recomendation for banks

1. Introduce of circularity/sustainability in the bank's strategic priorities.

2. Define concrete goals/objectives in the field of circular/sustainable economy.

3. Upgrade current risk assessment methodologies.

4. As creditworthiness becomes even more important establish a Circular Profile for bank‘s clients, which assesses the exposure of an entity’s operations to observable linear and circular risks and opportunities.

5. Integrate Circular-related Risks into Banks’ Capital Requirements.

Integrate Circular-related Risks into Banks' Capital Requirements

1. The Circular Supporting Factor relieves capital requirements for circular-friendly projects, making them more profitable and trying to close the circular finance gap.

2. The Linear Penalizing Factor could reduce credits to linear projects and help banks to bear losses from the materialization of circular-related risks.

Thank you.