Towards an EU strategy on sustainable finance

AFME's response to the questionnaire by the High-Level Expert Group on Sustainable Finance

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afme/
Finance for Europe

General Question

1. From your constituency's point of view, what is the most important issue that needs to be addressed to move towards sustainable finance? (sustainable finance being understood as improving the contribution of finance to long-term sustainable and inclusive growth, as well as strengthening financial stability by considering material environmental, social and governance factors). *1500 characters maximum (spaces included)*

    a. Unlock capital for small scale projects

We recommend the EU to continue the work on CMU to build its capital markets that will match the variety of project return and risk profiles and unlock the necessary risk capital to finance small infrastructure projects and businesses.

    b. Define an industrial strategy to build a financeable pipeline

The financing for infrastructures is available but there is lack of financeable projects. We recommend policymakers to define an industrial strategy resulting from other EU policy objectives (energy efficiency) to identify a pipeline and result in a better understanding of the risks to be financed.

    c. Support voluntary disclosures but avoid premature standardisation

We recommend better voluntary disclosures, focused on materiality, to improve investment decisions through the industry-led FSB TCFD work and the Non-Financial Reporting Directive. We also encourage policymakers to promote green labelling without constraining the development of this nascent market. We recognise the valuable work undertaken under the ICMA Green Bond Principles. Any proposal should be fully aligned at international level.

    d. Avoid using prudential regulation as a policy tool

We recommend policymakers to carefully consider any change in prudential regulation which could have unintended consequences on the stability of the financial system and the vital roles of banks in the real economy. Policymakers should focus instead on developing EU's capital markets under CMU.

The following questions cover selected areas that are addressed in the recommendations (chapter VI) of the interim report, which the expert group considers to be crucial and would appreciate your feedback on:

Develop a classification system for sustainable assets and financial products (Recommendation 1)

2. What do you think such an EU taxonomy for sustainable assets and financial products should include? 1500 characters maximum (spaces included)

In principle, we support the recommendations to provide a "strong, credible and long-term policy framework to drive investments" but work should be done on the underlying asset first, as a result of an EU industrial strategy.

Such industrial strategy should include incentives for users to create the demand for sustainable assets. For instance, an EU label on energy efficiency with adequate incentives for home owners would create a market which financial market participants would be able to respond to. A clear designation of "sustainable" assets can then serve as a basis for assigning those to eligible "sustainable" financing instruments.

In a later stage, a taxonomy for sustainable financial products should be formulated, aligned with the GBP, the TCFD and for instance the criteria in Art 63 CRR. It is critical that the taxonomy is fit for purpose and ideally global in its application and reach. This is challenging given sustainable finance and investment is rapidly evolving. The taxonomy should be clear, flexible enough to add new products and consider the categorisation of the underlying assets previously identified. This would provide sufficient clarity and encourage issuing instruments to finance of sustainable assets.

Establish a European standard and label for green bonds and other sustainable assets (Recommendation 2)

3. What considerations should the EU keep in mind when establishing a European standard and label for green bonds and other sustainable assets? How can the EU ensure high-quality standards and labels that avoid misuse/green-washing? 1500 characters maximum (spaces included)

We believe the ICMA GBP and CBI have served the market well to foster understanding of green investment categorisation and other criteria during the rapid growth of the green bond market. We believe they will continue to underpin this market. For green bonds and other sustainable assets, legislative initiatives on standards and labels may reduce the opportunities for creating or developing markets for sustainable assets.

A clear vision from policymakers is needed. We recommend a full review of EU's standards and incentives on the underlying relevant assets across sectors and geography. For instance, the Dutch government has sent a temporary energy performance certificate to 5m homeowners to trigger the demand for energy efficiency. As a result, a green RMBS certified by a rating agency was heavily oversubscribed showing great demand from investors for those assets[1]. Residential mortgages were labelled green as a result of high standards of energy efficiency on the asset itself.

After such review, we recommend the EU to coordinate its various green initiatives (e.g. Energy Union) and create a visible long-term industrial strategy.

Before the establishment of a EU standard can be considered, the HLEG should conduct a thorough review of existing standards applicable (GBP, CBI, Art 63 CRR and others) and geography. Only after a thorough review will we be in a position to understand what standards or labels are needed.

Create "Sustainable Infrastructure Europe" to channel finance into sustainable projects (Recommendation 6)

4. What key services do you think an entity like "Sustainable Infrastructure Europe" should provide, more specifically in terms of advisory services and connecting public authorities with private investors? 1500 characters maximum (spaces included)

We welcome the Commission's work on infrastructure finance including through the recent review in Solvency 2.

The EFSI has also successfully crowded-in private investors in deals that would have not been financeable otherwise, and we would welcome the inclusion of COP21 goals in the investment criteria for EFSI 2.

The EIAH is the natural place for municipalities bringing sustainable projects to receive technical expertise. We welcome the HLEG's recommendation to expand the EIAH remit to include sustainability considerations and increase its footprint by including regional offices. The creation of a separate dedicated organisation would however overlap and potentially conflict with the EIAH. Services of EIAH could be expanded to work alongside local and national authorities to:

-help them understand how private capital can accelerate the deployment of sustainable infrastructure solutions;

-improve the sustainability of currently investable assets by improving incentive mechanisms that would include measures on sustainability objectives;

- ensure that the scope of each project includes sustainability considerations at the procurement stage;

- monitor the achievements.

In order to support the EIAH, we recommend policy-makers to send a clear political signal by prioritising the sustainable sectors and defining specific actions to improve the demand for such assets. The European Investment Project Portal (EIPP) could be the main platform to create and manage a green European pipeline.

[1] https://www.aegonassetmanagement.com/global/News/News-Items/50-Shades-of-green-Investments/

The report also touches upon areas for further analysis. The following questions focus on a selection of these, which the group would appreciate your feedback on:

Mismatched time horizons and short-termism versus long-term orientation (Point 1)

5. It is frequently stated that the inherent short-termism in finance, especially financial markets, represents a distraction from, or even obstacle to, a long-term orientation in economic decision-making, including investments that are essential for sustainability. Do you agree with this statement?

- ○ Yes: If you agree with this statement, which sectors of the economy and financial system are particularly affected by the 'mismatch of time horizons'? What are possible measures to resolve or attenuate this conflict? 1500 characters maximum (spaces included)
- ● No
- ○ Don't know / no opinion / not relevant

We do not agree that finance is inherently short-termist. Finance solutions respond to specific demands from investors with long or short-term objectives. Investors may require short-term products for instance for hedging purposes or to respond specific investment strategies and many can also meet long-term objectives, e.g. provide financing or refinancing for long-term loans on an infrastructure projects. However, it is possible that factors such as regulations, tax, capital requirements, availability and symmetry of information, volatility, inflation and interest-rate levels influence the allocation of finance more in the short term or the long-term.

In addition, changes in regulations, laws and withdrawal of support during the life of transactions are a major obstacle to long-term finance. The withdrawal of support halfway through a long-term transaction turns a carefully analysed and understood project financing with the associated modest probability of default into a project which would not have received financing otherwise, with certainty of default and no hope of recovery as the assets cannot be economically redeployed. Scrutiny and guidance from the European level with regard to the stability of local support structures would be helpful.

Governance of the investment and analyst community (Point 2)

6. What key levers do you think the EU could use to best align the investment and analyst community with long-term sustainability considerations in the real economy? 1500 characters maximum (spaces included)

Bank research relies exclusively on public information to help clients take an appropriate decision. Disclosures to assess the risk and opportunities of sustainability is a source of new investment ideas. Such disclosures should, as intended, inform analysts (independent, buy-side or sell-side) from a pre-offer to the aftermarket. For a better appreciation of the impact of ESG on markets, the starting point is ESG reporting by companies based on what materially affect their business, sector, strategy. Such disclosure will enable investors to make better decisions. Banks can ask their clients for non-financial data if they are fully aligned with their reporting to other stakeholders. For unlisted companies, simple rating frameworks and easier access to rating services would help. Even simpler methods should be implemented for SMEs. Reporting standards should be verified by independent auditors.

We also support the current work and objective of the TCFD. We would not suggest codifying the recommendations as the EU is already making progress with the Non-Financial Reporting Directive.

Specific ESG training to analysts and fund managers can also be considered to develop best practices by EU institutions.

We encourage the promotion of sustainability with asset owners who are not yet PRI signatories to help building the capacity of smaller players to set sustainable mandate/requirements. Further, public bodies as issuers/investors themselves could issue and/or invest more in such assets.

A strong pipeline of sustainable projects for investment (Point 10)

7. How can the EU best create a strong and visible pipeline of sustainable investment projects ready for investment at scale? 1500 characters maximum (spaces included)

Policymakers could provide a more granular breakdown of the €180bn annual investments to meet the SDGs identified by the EIB both in terms of type of projects and sectors.

Identifying the demand will help market participants to consider the right type of financing e.g. debt/equity, public/private, and policy-makers to evaluate where market failures sit.

While there is a clear appetite for buying green infrastructure assets once operational, there is a smaller pool of investors keen to invest in the riskier end of the pipeline. But like any infrastructure projects, it is harder to generate investor demand for the early stage risk, where much of the political risk stands. After the financial close, public authorities should maintain consistency with regards to tariff-setting, laws and rules.

Other than some general comments, the HLEG does not appear to consider the influence of procurement approach on sustainability. The manner in which sustainability considerations can be integrated into a project will depend on how that project is procured.

Measures that would facilitate a strong pipeline of EU projects include:

-Focus public sector resources on procurement key areas, e.g. the timely provision of support to procurers by EIAH, or the timely intervention by national public sector procurement teams;

-Make public sector risk capital available to address constraints in private sector risk appetite e.g. for new projects or to accommodate political, regulatory and country specific risks.

Integrating sustainability and long-term perspectives into credit ratings (Point 3)

8. What are some of the most effective ways to encourage credit rating agencies to take into consideration ESG factors and/or long-term risk factors? Please choose 1 option from the list below

- ○ Create a European credit rating agency designed to track long-term sustainability risks
- ○ Require all credit rating agencies to disclose whether and how they consider TCFD-related information in their credit ratings
- ○ Require all credit rating agencies to include ESG factors as part of their rating
- ○ All of the above
- ◉ Other: Please specify what other ways you would deem most effective in encouraging credit rating agencies to take into consideration ESG and/or long-term risk factors. 1500 characters maximum (spaces included)

CRAs are active in communicating how they integrate ESG risk factors and how to use TCFD recommendations to improve sustainable investment decision-making.

Six of the world's leading CRAs made a public commitment to collaborative action on sustainability in an initiative with investors. Within this statement the CRAs affirmed their commitment to:

- Evaluate the extent to which ESG factors are credit-relevant for different issuers
- Publish their views transparently on how ESG factors are considered
- Review the ways ESG factors are integrated into credit analysis
- Maintain governance and resourcing to deliver quality ratings, including ESG analysis where relevant
- Participate in industry-wide efforts to develop consistent public disclosure by issuers on ESG factors that could impact their creditworthiness
- Participate in dialogue with investors to identify ESG risks to creditworthiness.

The commitments outlined above will enhance transparency in the ratings process, which often already incorporate ESG and long terms risks, enhancing the systemic and transparent consideration of ESG factors in the assessment of creditworthiness.

Many CRAs already incorporate environmental and climate risks into their ratings. CRAs have also published reports that explain how they facto ESG risks into its credit rating analysis. Additional disclosures with the TCFD's recommendations should over time further enhance its ability to take these risk factors into account in its credit analysis.

Role of banks (Point 7)

9. What would be the best way to involve banks more strongly on sustainability, particularly through long-term lending and project finance? 1500 characters maximum (spaces included)

The EU regulatory reform programme for banks has been considerable since the financial crisis with, amongst others, the CRR, aimed at improving the resilience of the financial system. With such ambitious changes already legislated, additional reforms need to be considered carefully.

Traditionally, banks were the main providers of infrastructure finance because of their ability to match funding to the long-term profiles of infrastructure projects.

But in a post-crisis world, banks are facing stricter capital charges and have to hold significantly higher buffers of capital which have had a knock-on effect on their ability to finance infrastructures.

Recently, policymakers started to investigate ways to reduce capital charges through specialised lending transactions. The proposal on the scaling factor for infrastructure exposures could play a vital role in ensuring that EU investment levels return to historical growth trends.

Additional requirements on banks would have destabilising effects on bank lending capacity. In case such approach should be considered, it is important that policymakers gather data to investigate a fact-based approach.

However, we strongly encourage policymakers to assess potential measures to support the soft and steady transition of EU into a low-carbon economy including with the CMU.

Policymakers and private stakeholders could also jointly assess changes to capital charges for mature renewable energy technologies and not require the use of listed debt funds.

Role of insurers (Point 8)

10. What would be the best way to involve insurers more strongly on sustainability, particularly through long-term investment? 1500 characters maximum (spaces included)

Insurers are already significant long-term investors in the European economy, with assets totalling almost €10tn and approximately 60% of EU GDP. Insurers have a natural capacity to invest long-term, which is given by the nature and profile of their liabilities. Such investments often support low carbon economies and include both debt and equity products.

AFME supports Insurance Europe’s three following key areas for the Commission to take action on:

1. Design of a taxonomy framework to help the clear identification of sustainable assets
2. Appropriate design and calibration of regulation for long-term investors such as insurers
3. Political support for an appropriate supply of long-term suitable assets

It should be stressed that the insurance industry supports the risk-based nature of regulations such as Solvency II and does not believe that prudential regulation should be used to provide artificial incentives to long-term investment. On the contrary, investigations should focus on identifying and removing disincentives, by appropriately designing and calibrating regulation aimed at recognising the actual risks faced.

For instance, AFME welcome the recent review of the capital charges for infrastructure investments in the project and corporate forms. After such review, it is now important that EU and national policymakers support the creation of credible pipelines on long-term sustainable assets.

Social dimensions (Point 12)

11. What do you think should be the priority when mobilising private capital for social dimensions of sustainable development? 1500 characters maximum (spaces included)

When mobilising private capital in sustainable projects, both the impact of the project on social welfare of stakeholders and the economic and financial rationale of the projects are considered as priorities.

The EU may want to create an EU initiative to implement the 2014 G8 Social Impact Investment Taskforce recommendations to help private capital tackle social problems.

In addition, initiatives could be explored to improve board of directors diversity in terms of gender, age, nationality, professional background and tenure for an efficient decision making process and sustainable company performance.

Other

12. Do you have any comments on the policy recommendations or policy areas mentioned in the Interim Report but not mentioned in this survey? 1500 characters maximum (spaces included)

AFME would like to note the following additional points:

- We support the proposal for Eurostat to redefine energy efficiency accounting rules.
- Availability of material data should be expanded for more aspects of sustainability and the number of companies for which this applies to. For instance, EU sector associations could be asked to build on this data and develop and expand social and environmental metrics for their specific sectors (i.e. amount of clean water/day provided, number of people trained). Companies could then be encouraged to report against these metrics. EU sector associations could aim to support efforts to establish a global positive impact metric for their sector. Expanding the availability of comparable positive impact metrics will make it easier for investors to measure the positive impact of public equity and debt funds.
- The recommendations should consider financial stability during the whole life of the projects as well as contribute to systemic risk mitigation.

13. In your view, is there any other area that the expert group should cover in their work? 1500 characters maximum (spaces included)

    We would like to emphasise that the efforts taken should not be limited to the financial sector only. As the financial sector serves the real economy, the HLEG should focus on cross-industrial efforts, and the major roles that governments need to play.

    The Expert Group might also consider covering some other social potential opportunities related to sustainability such as financial inclusion, educational financing or affordable housing.

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