THE VOICE OF PRIVATE CAPITAL
VENTURE CAPITAL
PRIVATE EQUITY
INFRASTRUCTURE
LONG TERM INVESTORS

Questionnaire by the High Level Expert Group on sustainable finance interim report

Invest Europe response

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)

Invest Europe response:

1. As a starting point, we would like to express our support for the work of the HLEG and the direction taken in the Interim Report. The early recommendations for policy action are highly relevant and help to highlight the important role that an asset class like private equity can play in promoting sustainable development. If implemented they will contribute to a more efficient and sustainable financial system.

2. Private equity investors' expertise lies in analyzing information to identify attractive, long-term investment opportunities. Optimal investment decisions are made if all relevant information (financial and non-financial) is taken into account, which includes appropriate ESG factors.

   In order to improve the contribution of investors to long-term sustainable growth, they need to acknowledge that ESG factors are relevant for making optimal investment decisions. With an increasing number of private equity investors actively adopting ESG policies and practices, the industry has shown that it recognizes that these factors contribute to better investment decisions (though the situation and practical application will vary from one investor to another).

3. Clarity and certainty on how governments are willing to support the transition to a more sustainable economy will accelerate investors' moves into sustainable investments (and away from non-sustainable investments). This includes setting forth well-defined and clearly communicated objectives. These are too often fragmented and often focus on specific topics, e.g. climate change, but do not provide a coherent overall perspective on sustainability.

4. Furthermore, we believe it is crucial to address the current inconsistency of public policy which talks about encouraging long-term, sustainable finance but also includes punitive regulatory treatment for institutional investors who provide long-term debt or equity investment. For example, regulatory capital charges under Solvency II are unnecessarily high level for private equity or long-duration debt. Existing regulation and any amendments to it should not work against or hinder investment in a long-term asset like private equity.

5. Finally, it is important to reflect on the critical role that market prices play in financial decision making. The prices that the financial sector relies on for its analysis and to inform its decisions need to take account of sustainability issues and build in ESG implications. Currently, an asset's market price will not reflect its environmental and social impact because the tax, regulatory and other policies that internalise such costs are not in place. The HLEG's report suggests adjusting existing regulation impacting the sector, such as AIFMD or Solvency II, to encourage greater investment but this will not tackle the whole problem. We need to work towards sustainability with a 'whole economy' approach.

Develop a classification system for sustainable assets and financial products

Question 2 - What do you think such an EU taxonomy for sustainable assets and financial products should include?

Invest Europe response:

1. The taxonomy/classification system for *sustainable assets* should be: (i) international, not specifically designed for the EU, (ii) based on widely accepted international standards and definitions that already exist for different asset classes and (iii) unambiguous and practical. It should include a set of clearly defined criteria that define a sustainable asset.

2. Asset owner support will also be essential as they are the ultimate source of capital.

3. Another consideration to make is whether this taxonomy would be a legal requirement in some way (i.e. hardwired in legislation) or – more rightly in our view - an advisory taxonomy (i.e. a set of criteria that those involved can use voluntarily).

   The former approach requires policymakers to be entirely confident that the criteria for determining that an asset / investment is 'sustainable' are correct. The wrong criteria, set out in law, risk encouraging *less* sustainable practices.

   A legislative approach also risks being less flexible and adaptable, unable to be amended easily as understanding of sustainability issues develops.

4. Policymakers should also be clear about the purpose and use of an EU taxonomy. They should make sure that it captures all elements of sustainability and be mindful of trade-offs between the different components of sustainability in a broader sense. For example, if a certain initiative/project/investment is positive for the environment, it may not necessarily be sustainable from a social policy perspective in the short term. Any taxonomy needs to address these complex interactions.

   Policymakers should therefore be careful not to end up biasing / favouring certain aspects of sustainability over others, thus creating distortions and new forms of unsustainable finance.

5. We would be happy to share further views on an EU classification system once more detail is known. Ultimately, the aim should be to foster a broad mindset, which truly embraces the principles of ESG, rather than a check-list approach.

Establish a European standard and label for green bonds and other sustainable assets

Question 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?

Invest Europe response:

Invest Europe feels strongly that it would not be beneficial for the EU to come up with yet another standard and label for sustainable assets. Instead, it should build on – and be aligned with - widely accepted international labels and standards that already exist for different asset classes.

In any case, there are a few observations that should be carefully considered in the development of standards, labels or classifications:

1. an international label for sustainable assets should include a set of clearly defined criteria, such as clear environmental and social focus/benefits, long-term focus, etc.

2. it will be important to consider the full picture when defining what is good for society. A simple check-list would not be appropriate. An overall 'negative' (i.e. unsustainable) investment strategy should not be able to receive a sustainability standard/label simply because it fulfils certain positive criteria.

3. all standards need to take into account the evolution of sustainability and hence not be too static - adapting to both the changing agenda and how 'good practice' moves forward.

4. what institution would provide such a label and what cost will be associated with it?

Any link between such criteria and legislation setting prudential capital requirements for financial institutions would need careful consideration. Financial stability is the key purpose of capital requirements rules and if they are amended to promote sustainable finance goals their prudential objectives must not be undermined. How do we evidence and provide data to justify a lower capital requirement for a 'sustainable' investment?

This reinforces the view that a taxonomy should be voluntary. On the basis of evidence, a regulatory approach could then be considered.

Create "Sustainable Infrastructure Europe" to channel finance into sustainable projects

Question 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?

Invest Europe response:

Investors will generally have a positive attitude towards initiatives that improve access to attractive investment opportunities. However, before creating a new body, the question should be posed whether the potential of *existing* bodies to perform the same role has been explored.

It may be more efficient to make better use of, and to improve the quality and capacity of the existing bodies, before creating something new.

Mismatched time horizons and short-termism versus long-term orientation

<u>Question 5</u> - 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?

<u>Invest Europe response</u>:

Multiple choice: Yes – No – Don't know/No opinion/Not relevant

Yes, when the question refers to financial markets overall, where assets are traded on a short-term basis.

1. As a starting point we would like to challenge the premise on which the question is based, i.e. that finance is inherently short-term. There are <u>different types of finance</u> and <u>different assets in finance</u>. There are long-term players in finance, of which private equity is one - providing a long-term approach to its investors and investments, thus helping to build sustainable businesses.

2. Given its characteristics private equity is already closely linked to sustainable finance and development. Private equity is foremost <u>an active ownership and management model</u> for investments in privately held companies of all sizes and at all stages of development. The nature of the <u>long-term partnerships</u> formed through negotiations and ongoing interactions between fund managers and investors, as well as fund managers and their portfolio companies is fundamental to how the industry operates and sets it apart from other asset classes.

   Given this <u>hands-on active stewardship</u> of businesses and <u>long-term ownership timeframe</u>, as an asset class private equity is particularly well suited to integrating and managing ESG matters.

3. Against this background, <u>one single solution</u> on sustainable finance <u>would not be appropriate</u>. While it is important to take account of (the characteristics of) long-term investment strategies like private equity, it should be recognized that short-term finance and instruments (like borrowing facilities) also have a role to play. Long-term investment strategies often need to use certain short-term instruments to function effectively.

4. Furthermore, many investments that are essential for sustainable development are available in private equity, infrastructure and other alternative asset categories which are <u>long-term in nature</u>, <u>less liquid</u> and hence, higher risk. However, many asset owners have very limited (or no) exposure to alternatives in many EU countries, and hold most of their assets in liquid, listed equities where short-termism is very present. As a result, there is a <u>mismatch</u> between the supply of sustainable, long-term investments and institutional demand for them.

5. Finally, we would emphasise the need to address the <u>inconsistency of public policy</u> which talks about encouraging long-term, sustainable finance but also includes punitive regulatory treatment for institutional investors who provide long-term debt or equity investment.

Governance of the investment and analyst community

Question 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?

Invest Europe response:

1. As a starting point, we would like to re-emphasise:

    a. that regulatory and tax measures need to reflect sustainability. It is important to get the fundamental prices of downstream assets right, through the appropriate use of tax and regulation (see also Question 1). The lack of capacity/ knowledge/interest by investment analysts in taking ESG into consideration when analysing public equities plays a role in this. If prices take into account sustainability issues (like the cost of carbon emissions, etc.) then that would go a long way to solving the problem. We need to ensure upstream that the pricing attached to those assets already takes better account of sustainability issues.

    b. our concern about the (in)consistency of the public policy framework. For example, Invest Europe's infrastructure fund members have often expressed concerns around the lack of stability and certainty in domestic policy as it applies to infrastructure. We had a stark example of this five years ago when, following significant investments by our members into Spain's renewable energy sector, the government announced three major retroactive changes to renewable energy contracts. As a result, the economic case for millions of euros of investment into valuable ecological projects was undermined. Infrastructure funds are typically held for 10 or 15 years – sometimes longer – so they need a stable and predictable regulatory environment in order to deliver returns to their investors. This government's action has deterred fund managers from making further investments in this country. In short, the capital is there and investors are keen to put it to work, but there are more factors at play in mobilising long-term capital into sustainable projects.

2. Increasing transparency and exploiting the possibilities from increased digitalization and automation will also help as financial and non-financial data can be collected and made available "live" to investors and analysts.

    An understanding and appreciation that certain transformations have a longer pay-off period, e.g. investments for more sustainable operations, needs to be stimulated. A company's choice to make long-term investments to future-proof their business should not be penalized by a short-termist financial system.

3. Finally, policymakers/regulators can assist in the move towards sustainable finance by providing public economic, environmental and social data scenario models and visualizations of such scenarios. In addition, we believe it is important to advance the awareness and concept of how countries are evaluated, i.e. moving from GDP to other measures such as GPI (Genuine Progress Indicator) and IWI (Inclusive Wealth Index). The same should be considered in terms of the relationship with stock exchanges and in the field of accounting standards, i.e. moving from FASB/IASB and SASB/GRI to ASB.

A strong pipeline of sustainable projects for investment

Question 7 - How can the EU best create a strong and visible pipeline of sustainable investment projects ready for investment at scale?

Invest Europe response:

A pipeline of sustainable investment projects is and will be created by market participants throughout the investment chain. The EU can facilitate this process by:

- providing clear regulation that will foster long-term investments focused on the areas most vital for sustainable development;
- providing catalyst capital for the development of public-private partnerships that will help attract private capital to sustainable assets in later stages;
- setting up a simplified, user-friendly platform of dedicated financial programmes (e.g. EFSI) that will provide a good overview of the funds available for sustainable development in Europe. Currently one needs a consultant to get through the maze of different programmes and funds;
- stimulating and enforcing greater transparency on ESG integration and the social and environmental impacts of different types of products through regulation.

Integrating sustainability and long-term perspectives into credit ratings

Question 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 one option from the list:* *(i) Create a European credit rating agency designed to track long-term sustainability risks* *(ii) Require all credit rating agencies to disclose whether and how they consider TCFD-related information in their credit ratings* *(iii) Require all credit rating agencies to include ESG factors as part of their rating* *(iv) All of the above* *(v) 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* (max 1500 characters including spaces)

Invest Europe response:

Option (iii) - Require all credit rating agencies to include ESG factors as part of their rating

A credit rating agency assessment of credit risk should specifically consider potential liabilities and/or diminution of value due to environmental, social and governance failings. Addressing and managing these risks should be rewarded with a stronger credit rating.

Role of banks

Question 9 - What would be the best way to involve banks more strongly on sustainability, particularly through long-term lending and project finance?

Invest Europe response:

N/A

Role of insurers

Question 10 - What would be the best way to involve insurers more strongly on sustainability, particularly through long-term investment?

Invest Europe response:

1. Attention should be paid to the inconsistency of public policy which talks about encouraging long-term, sustainable finance but also includes punitive regulatory treatment for institutional investors who provide long-term debt or equity investment. For example, regulatory capital charges under Solvency II are unnecessarily high level for private equity or long-duration debt. However, it is not long-term investing that is risky, it is asset-liability mismatches. Longer-term debt or equity investments may / will be more risky for a bank whose liabilities are short term (deposits and capital market borrowing) but should not be seen as high risk for a pension fund or insurance company which has long-term liabilities.

2. Within this context, it is also important to keep in mind that some insurers are (already) active in long-term assets like private equity though there is scope for more to be done if our regulatory concerns regarding capital requirements under Solvency II were to be addressed. Not all finance is short-term and not all financial players are high-frequency traders. There are bits of finance that are already long-term, taking sustainability into account (like insurance companies and pension funds). Private equity is a long-term industry and we should avoid any regulation that works against this.

Social dimensions

Question 11 - What do you think should be the priority when mobilising private capital for social dimensions of sustainable development?

Invest Europe response:

1. We believe it is important to direct EU funds at social investments/programmes/ enterprises that have the potential to develop scale and be financially viable. Private – institutional – capital will only support the enterprises and (social impact) funds that offer market-based risk-adjusted returns.
2. Furthermore, it will be crucial to define priority social impact areas, set targets and design plans for their realisation.
3. One should also think about sustainability in the round. Sustainability cannot and should not be broken apart into different components. It has to be integrated from the beginning.

   Energy is a good example of this. Financing environment-friendly, green energy may lead to higher prices and thus create a social issue because people cannot afford it. On the other hand, in an attempt to keep prices down, certain environmental issues may be ignored thus creating environmental problems.

Other

Question 12 - Do you have any comments on the policy recommendations or policy areas mentioned in the Interim Report but not mentioned in this survey?

Invest Europe response:

- As alluded to above, we believe it is important to avoid the introduction of EU-specific sustainability institutions, agencies, labels, etc. Companies and financial institutions and markets are international in nature, or operate in an international environment, and region-specific standards will not help stimulate the acceptance of sustainable finance.

- An important area, as highlighted several times under *Policy areas for further discussion and analysis*, which we agree should be investigated further, is ensuring long-termism in investment decisions and reporting arrangements.

  Additionally, on the topic of reporting and disclosure, the HLEG discusses the lack of mainstream reporting information. When looking for new standards to find a new mainstream, it should be clear how this links to/'over-rules' other current standards.

- Furthermore, as highlighted in the material, the importance of aligning the final recommendations with the sustainable development goals, the world's 2030 agenda, is key.

Question 13 - In your view, is there any other area that the expert group should cover in their work?

Invest Europe response:

- While all relevant areas seem to be covered, we would strongly encourage another consultation period by the HLEG once more progress has been made. Theoretical recommendations are one thing, practical implementation another. While it may be relatively easy / straightforward to agree with the recommendations in theory, we are convinced that a more practical implementation proposal will trigger additional feedback from stakeholders. See also point 4 of Question 6.