DRAFT – Not for public dissemination

Response to European Commission Consultation on the Green paper on the long-term financing of the European economy

Draft version 1 – 18 April, 2013

Eurosif[1], the European Sustainable Investment Forum, welcomes this Consultation on the Green Paper on the long-term financing of the European economy. The challenges faced by Europe to achieving the sustainable economic growth needed to escape the current crisis have been well documented[2]. They include the lack of available financing, especially for long-term projects and SMEs; political and regulatory barriers to encourage financing of investments that promote environmental and social sustainability; lack of trust in the financial sector; and excessive short-term behaviour in financial intermediaries.

According to the Commission, "[t]he purpose of this Green Paper is to initiate a broad debate about how to foster the supply of long-term financing and how to improve and diversify the system of financial intermediation for long-term investment in Europe."[3]

Eurosif contends that (i) the long-term financing of the European economy cannot be decoupled from the environmental and social challenges facing Europe and the world, and that any investment that claims to be long term must also be aligned with Europe 2020[4] objectives for smart, sustainable and inclusive growth. Additional longer-term considerations are also tied to long-term investment strategies, including the climate and energy strategy to 2030[5] and the roadmap for moving to a low-carbon economy in 2050[6]. Further, (ii) the long-term investing[7] covered in this Green Paper is important, but does not encompass all facets of the debate. Eurosif argues that, by initiating this debate on long-term financing, the Commission has the opportunity to address and reassess the core objectives and functioning of financial markets, in order to again place Europe at the forefront of sustainability in all aspects of society including finance.

Eurosif would therefore urge the Commission to better address at least two additional areas of importance in the scope of long-term investing, as these areas are not adequately covered by the Green Paper:

- How can investment in long-term productive capital be better aligned with Europe's social and environmental ambitions?
- How can investors and financial intermediaries be encouraged (and allowed) to adopt investment horizons that are more closely matched to those of their long-term beneficiaries?

[1] Interest Representative Register ID number: 70659452143-78
[2] [Source needed]
[3] Commission Green Paper, page 6.
[4] "Europe 2020 is the European Union's ten-year growth strategy. It is about more than just overcoming the crisis which continues to afflict many of our economies. It is about addressing the shortcomings of our growth model and creating the conditions for a different type of growth that is smarter, more sustainable and more inclusive. To render this more tangible, five key targets have been set for the EU to achieve by the end of the decade. These cover employment; education; research and innovation; social inclusion and poverty reduction; and climate/energy." Source: http://ec.europa.eu/europe2020/europe-2020-in-a-nutshell/index_en.htm
[5] http://ec.europa.eu/news/energy/130404_en.htm
[6] http://ec.europa.eu/clima/policies/roadmap/index_en.htm
[7] In this response, long-term investing, long-term financing and the acronym LTI are synonyms.

It is worth reminding the Commission that, in its own words, "[s]ustainable growth means:

- building a **more competitive low-carbon economy** that makes efficient, sustainable use of resources
- **protecting the environment**, reducing emissions and preventing biodiversity loss
- capitalising on Europe's leadership in developing **new green technologies** and production methods
- introducing **efficient smart electricity grids**
- **harnessing EU-scale networks** to give our businesses (especially small manufacturing firms) an additional competitive advantage
- **improving the business environment,** in particular for SMEs
- **helping consumers** make well-informed choices."[8]

Eurosif urges the Commission to consider these goals in any proposed policy action related to long-term investment and finance.

It is our view that the Green Paper does not give sufficient attention to key policy areas including support for a more competitive low-carbon economy, protecting the environment and developing new green technologies. This lack of alignment of the long-term financing debate with the core goals of the EU is alarming, and Eurosif would urge the Commission to use this opportunity to align policy with action to its fullest extent. While growth and employment are understandably the current short-term priorities of the EU, these goals must not compromise the long-term aims of achieving sustainable growth.

It is encouraging that European policy makers have acknowledged that a shift in the balance of capital allocation away from short-term to long-term is needed in order to help restore confidence in the financial industry, nevertheless this Green Paper reads like a missed opportunity to address the core failures of the financial sector that have contributed to excessive focus on short-termism in investment. While it is undoubtedly important to find innovative ways to increase Europe's long-term productive capital stock at a time when governments are fiscally challenged, this does not encapsulate all the issues of short-term behaviour in capital markets that have contributed to the financial crisis in Europe.

<u>Summary of Eurosif Positions on Long-term investment</u>

Long-term investing is not only an asset class such as infrastructure, nor is it limited to a characteristic of the investment such as liquidity, nor is it constrained to long-lived capital. Long-term investing is an asset management philosophy that emphasises patient capital associated with long-term growth of productive assets, as opposed to short-term pricing of those assets. The assets are not key to long-term investing, the management of those assets is. That said, we acknowledge that some specific asset classes are more prone than others to long-term investing and support the idea of a specific legal framework to channel more investments into these, as long as this does not give the impression that all other assets are not long term and doe not overshadow the need to incentivise broad capital markets to behave in a more long-term manner.

Long-term investors should take into consideration environmental, social and governance (ESG) issues in the management of assets, and align this with the needs and expectations of their beneficiaries. The motivations for incorporating ESG issues can include better risk management, seizing opportunities from changing patterns of demand, and aligning asset management with moral and ethical beliefs.

Asset owners must evaluate and formalise their approach to ESG in a policy document. They have a responsibility to ensure that asset managers incorporate ESG issues in their management activities and act in a manner that is consistent with asset owner expectations.

Legislators must look at the entire chain of intermediaries between beneficiaries and asset managers to identify and seek to rectify areas where perverse incentives can lead to short-term behaviour.

[8] http://ec.europa.eu/europe2020/europe-2020-in-a-nutshell/priorities/sustainable-growth/index_en.htm

Key Demands
Transparency – Asset owners, asset managers and intermediaries must be transparent about whether, to what extent and how they incorporate ESG concerns for the benefit of beneficiaries.

Alignment of Incentives – Key areas of corporate governance legislation and recommendations must be revisited to improve the alignment of corporate behaviour with investor expectation.

Incentivise Stewardship and Remove Barriers to Engagement – Asset owners should be encouraged to become more active owners, and certain barriers to long-term asset management and effective shareholder stewardship must be addressed.

This response has been developed as a part of Eurosif's aim to develop sustainability through European financial markets. It does not necessarily reflect the views of all its Members and Member Affiliates.

Section 2: The Supply of Long-term Financing and Characteristics of Long-term Investment

Question 1: Do you agree with the analysis out above regarding the supply and characteristics of long-term financing?

Question 2: Do you have a view on the most appropriate definition of long-term financing?

Characteristics of long-term financing
"Long-term investment is the formation of long-lived capital, covering tangible assets (such as energy, transport and communication infrastructures, industrial and service facilities, housing and climate change and ecoinnovation technologies) and intangible assets (such as education and research and development) that boost innovation and competitiveness. Many of these investments have wider public benefits, since they generate greater returns for society as a whole by supporting essential services and improving living standards. Their impact can also begin to be felt in the short term. They enable companies and governments to produce more with fewer resources, responding to new economic, social and environmental challenges, facilitating the transition to a more sustainable economy and raising the productive and industrial capacity of the economy. Trends in climate change and the depletion of natural resources further underline the sustainable growth challenge, as they call for more long-term investment in low-carbon energy, energy and resource efficiency and infrastructure, consistent with the political objective of limiting climate change below two degrees and decoupling economic growth from resource use." (European Commission Green Paper, p. 2)

"The long-term growth prospects of any economy depend inter alia on the financial sector's ability to channel the above-mentioned sources of savings into productive investment. This Green Paper is concerned with long-term investment in the sense of the formation of long-lived tangible and intangible capital. The focus is thus on productive (as opposed to financial) capital similar to the concept of the national accounts in which investment is specified as gross fixed capital formation." (ECGP, p. 5)

"The focus is put on long-lived capital goods (such as economic and social infrastructure, buildings and R&D, education and innovation), not because they are more important for growth than shorter-lived capital goods (such as computers, mobile phones and vehicles). Rather, investment volumes for short-lived capital goods are strongly pro-cyclical." (ECGP, p. 5)

"There is no single, universally-accepted definition of long-term financing. In broad terms, long-term financing can be considered as the process by which the financial system provides the funding to pay for investments that stretch over an extended time period. This definition focuses on the range of features associated with long-term finance. Alternatively, on-going international work under the auspices of the G20 on long-term investment defines long-term finance more narrowly, focusing on maturities of financing in excess of five years, including sources of financing that have no specific maturity (e.g. equities)." (ECGP, p. 5)

Supply and Characteristics of LTI

Eurosif agrees with the Commission that the formation of long-lived capital goods can be classified as long-term finance. These assets, whether private or public, will generally be classified as long-term assets on the balance sheet and financed according to the return (financial or other) they generate over the life-time of the asset. However, long-term investing and financing encompasses a lot more than long-term capital goods, and Eurosif would urge the Commission not to unduly restrict the debate on long-term investing. Having a broader, more holistic view makes for better policy making, as more options for action can be considered and additional facets of impact can be assessed. It also reduces the risk of putting in place legislation that is overly distorting on the market. Eurosif is of the opinion that the aim of action from legislators should be to encourage a longer-term view of finance (similar to that of companies' investment decisions) without necessarily changing the asset mix of investment portfolios. This can be achieved through changing incentives and establishing frameworks for long-term investing.

Definition of long-term investing

In the UCITS V consultation[9], the Commission described long-term investing in terms of characteristics: projects with long time horizons, infrastructure financing, and stable returns that are less correlated with the market. Eurosif argued that other types of investments can (or should) incorporate a long-term perspective and that this should not be forgotten in the drive to generate the change needed to reorient the markets to a more long-term perspective[10].

In the Green Paper on long-term financing, the Commission takes a different path by limiting LTI to investments that support the formation of long-term productive assets. However, dividing finance into long-lived and short-lived capital goods misses the fact that short-term capital goods also require long-term finance. Despite the Commission using a different scope and point of reference in LTI and UCITS, the point of Eurosif remains valid: increasing long-term finance does not necessarily entail reallocating assets in investment portfolios; rather it requires a change in how portfolios are managed.

The rationale for the stance of Eurosif is that, in limiting long-term investing to capital goods that require long-term financing, there is a danger of overlooking a significant portion of the market that does invest long-term in shorter-lived capital goods. Producers of computers, mobile phones and vehicles also require long-term financing despite the pro-cyclical nature of demand for their goods, and producing incentives for private finance in certain (public) capital goods without considering wider impacts could, for example, crowd out financing of consumer goods.

That is not to say that there should be no incentives for long-term investing or private financing of public goods, and Eurosif is supportive of an increase in long-term finance of the real economy. Nevertheless, we would draw attention to some of our concerns, including that an appropriate structure and balance of policy action is important. For example, if investors only shift investments from one long-term investment to another without increasing overall allocation to long-term finance the objective of the action would have failed. Another example is if allocation to specific long-term oriented assets increases marginally but no critical mass is achieved in terms of the overall capital markets.

Private Finance of Public Goods

Beyond the characteristics of LTI and the definition, Eurosif is concerned about the overall aim of the policy initiative. In the LTI consultation, the Commission appears to primarily be concerned with creating new long-term productive assets in areas that typically have been financed by public funds. This entails a shift of financing whereby public works projects (e.g. infrastructure) are established by governments, but are financed

[9] See: http://ec.europa.eu/internal_market/consultations/2012/ucits_en.htm

[10] See: http://www.eurosif.org/policy/positions for the full consultation response.

and produced the private sector. In essence the burden of government to finance public goods is shifted to the private sector, and the consultation is tasked with establishing the right incentives for this capital formation.

However, it is no accident that the capital goods referred to in the paper (energy, transport and communication infrastructures, industrial and service facilities, housing, climate change and ecoinnovation technologies, education and research and development) are to a large degree financed by public finances, since they produce positive public externalities that are typically not sought (or valued) by private investors. Even with the (gradual) change in attitude among some (niche) investors seeking positive environmental or social impact alongside financial return, the funds available are dwarfed by the needs identified by the Commission. Thus, the availability of risk-financing for such projects is almost non-existent. Only with public finances providing risk-bearing tranches and/or financial incentives and stable political conditions will significant private funding be available, and even without shifting the risk to the private sector financing may not be available in the amounts needed.

The Importance of ESG Factors in long-term finance

Central to this debate, and a point that has been largely overlooked by the Commission, is that the risk/return profile of long-term investments is particularly sensitive to environmental, social and governance (ESG) concerns.[11]

ESG factors come into this debate in at least three forms:

- Beneficiaries of the investments are more likely to see better risk/return profiles in the long term if investments take into account ESG issues. This is especially important for pension and insurance assets, whose final payouts are very sensitive to small changes in compound returns over very long time horizons.
- The investors that support the projects need to take into account ESG issues as part of their fiduciary responsibility to beneficiaries[12]. For example, a pension fund whose current obligations will extend up to a century in the future should employ fund managers who look beyond expected cash-flows for the next six months[13]. Therefore, it is important to take into account ESG issues not just at the time of the investment, but over the life-time of the project.
- The projects themselves have a long-term impact on society, communities and the environment. Society will benefit from the positive social and environmental externalities produced (or negative avoided), and by ensuring that long-term investments are aligned with the future political ambitions of the EU in terms of achieving sustainable growth.

Institutional and other investors are becoming more interested in the long-term holdings mentioned in the Green Paper such as infrastructure investments, and it will be critical for the success of these projects that ESG concerns are addressed over the lifetime of the project.[14] In addition, long-term investors such as pension funds, insurance companies and sovereign funds are not restricting their interest in long-term asset management to such investments, but are often forming a long-term view for all investments. Hence, the importance of ESG factors can be extended to all asset classes and should, as such, form an integral part of any long-term investment philosophy. The wider benefit to society from a long-term view of investments incorporating ESG concerns in asset management will come from a reorientation to a long term view by investment managers.

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[11] See for example: DB Climate Change Advisors (2012), “Sustainable Investing: Establishing Long-Term Value and Performance”; The International Institute for Sustainable Development (2012), “Financial Stability and Systemic Risk: Lenses and Clocks.”

[12] See for example: UNEP FI (2009), “Fiduciary responsibility.”

[13] There are a number of specific examples to support the assertion, such as the effect of the 2010 Deepwater Horizon incident on the value of BP.

[14] See inter alia Eurosif’s report on Infrastructure and the European SRI Study 2012, both available on the Eurosif website.

<u>Eurosif Position on Long-term investing and finance</u>
Long-term investing and finance is an investment philosophy that emphasises long-term growth of productive assets, as opposed to short-term pricing of those assets. Long-term investing is not an asset class such as infrastructure, nor is it a characteristic of the investment such as liquidity, nor is it restricted to long-lived capital. The assets are not key to long-term investing, the management of those assets is.

Long-term investing can be encouraged and facilitated by developing appropriate investment vehicles or risk-sharing facilities. One example is a long-term UCITS fund framework. However, this is not sufficient to move significant (institutional) assets into long-term asset management.

Ultimately, one needs a shift in behaviour. This cannot be directly legislated, but policy makers can encourage and influence a shift in behaviour through supporting education, mandating disclosure, ensuring the alignment of incentives, and facilitating communication.

<u>Eurosif Demands</u>
Transparency – Disclosure requirements for investors can be a very powerful vehicle for encouraging long-term behaviour in investment management, as it not only requires investment boards to assess whether assets are managed in a manner consistent with fiduciary duty, but provides information to beneficiaries about the quality of investment management. Eurosif therefore considers that asset managers and asset owners should disclose whether and to what extent they take ESG considerations into account in their asset management and selection. Eurosif also encourages disclosure of how investors manage their relationship with investee companies through shareholder stewardship codes.

Alignment of Incentives – The proper alignment of incentives between investors and companies can lead to better functioning of financial markets and better long-term management of assets. In this regard, there should be increased transparency of remuneration for directors of both financial institutions as well as for all listed companies to shareholders.

Section 3: Enhancing the Long-term Financing of the European Economy

Section 3.1: The capacity of financial institutions to channel long-term finance

<u>Commercial banks</u>
Question 3: Given the evolving nature of the banking sector, going forward, what role do you see for banks in the channelling of financing to long-term investments?

<u>National and multilateral development banks and financial incentives</u>
Question 4: How could the role of national and multilateral development banks best support the financing of long-term investment? Is there scope for greater coordination between these banks in the pursuit of EU policy goals? How could financial instruments under the EU budget better support the financing of long-term investment in sustainable growth?

Question 5: Are there other public policy tools and frameworks that can support the financing of long-term investing?

<u>Institutional investors</u>
Question 6: To what extent and how can institutional investors play a greater role in the changing landscape of long-term financing?

Question 7: How can prudential objectives and the desire to support long-term financing best be balanced in the design and implementation of the respective prudential rules for insurers, reinsurers and pension funds, such as IORPs?

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Question 8: What are the barriers to creating pooled investment vehicles? Can platforms be developed at the EU level?

Question 9: What other options and instruments could be considered to enhance the capacity of banks and institutional investors to channel long-term finance?

<u>The combined effects of regulatory reform on financial institutions</u>
Question 10: Are there any cumulative impacts of current and planned prudential reforms on the level and cyclicality of aggregate long-term investing and how significant are they? How could any impact be best addressed?

<u>Commercial banks</u>
"Banks have traditionally been the most important financial intermediaries in Europe. The share of the banking sector in the EU is large by international comparison, especially compared to the US, reflecting Europe's greater dependency on bank intermediation. Going forward, this creates challenges for long-term financing." (ECGP, p. 5)

"The recent report of the High-level Expert Group on reforming the structure of the EU banking sector documents how bank behaviour in recent decades has led to a disproportional increase in intra-financial business, rather than customer-facing activities, including long-term financing for companies." (ECGP, p. 6)

Commercial banks are an important source of finance for corporations and provider of savings products for households (retail investors). However, availability of finance has been restricted in recent years, in part due to higher capital requirements and uncertainty in the inter-bank lending market. In order to restore bank financing, adjust incentives and ensure availability of financing for sustainable growth, the Commission should seek to:

- Restore trust in retail and commercial banks so they are seen as safe for savers and consistent providers of financing for households and commercial enterprise (especially SMEs).
- Address perverse incentives in financial intermediation such that intermediation serves end users.

The rapid growth of ethical and local community banks in some European markets is endemic of the lack of trust in commercial banks, many of whom did not manage risks effectively during the financial crisis. This alone may not provide additional assets to finance long-term investments, but restoring trust should make more finance available, including for long-term projects.

However, it is not evident that the expertise of banks lies in the funding of large public projects such as infrastructure. It is also likely that any move in this direction will once again expose commercial banks to risks that may be difficult to manage in the event of another short-term liquidity crisis. Therefore, the main focus of legislators should be to restore trust in commercial banks and ensuring that they have adequate solvency ratios. This should enable banks to restore lending to businesses, especially SMEs, and continue to support growth and employment.

<u>Development banks</u>
"Despite the positive net contributions of certain investments to economic welfare, market failures can prevent investors from taking certain risks and/or making certain investment decisions. In these instances, national and multilateral development banks can be useful in stimulating private financing given their specific public policy objectives related to broader economic, social and environmental (as opposed to purely financial) value added. Provided they focus on proven market failures, their involvement can fulfil an important countercyclical role, including by reducing the volatility of funding costs for certain categories of investors and mitigating the short-termism of private actors. Importantly, the governance of development banks should ensure that they do not use their funding-cost advantage to crowd out private financing. Rather, they should strive to catalyse private financing in areas where it is slow to come forward." (ECGP, p. 6)

Development banks, whether they are national, regional or international have a history of financing long-term public benefit projects such as infrastructure. They are also often the vehicles chosen to finance projects that have positive environmental or social externalities. In addition, many have experience with public-private partnerships and using risk-sharing facilities to attract institutional investors. However many of these funds are focused on financing projects in developing countries, not just within Europe. This is especially the case for national development banks, although the European Investment Bank is an exception.[15] It is likely that additional development bank funds could be used for long-term investment in Europe, however this may require additional funding or diverting assets from international investments. Institutional investors may be able to provide some funding, but the challenge in deploying institutional funds through development banks is that there are many international development institutions competing for the same funds, and many of these are not focussed on Europe.

<u>Institutional investors</u>

"Given the longer time horizons of their business models, institutional investors – such as (life) insurance companies, pension funds, mutual funds and endowments – represent suitable providers of long-term financing. Together, they hold an estimated total of €13.8tn of assets, equating to more than 100% of EU GDP. Other institutional investors – such as sovereign wealth funds, dedicated infrastructure funds and, to some extent, private equity – have also emerged as providers of long-term capital. Venture capital can also provide long-term finance." (ECGP, p. 8)

"The long duration of their liabilities allows institutional investors, at least in principle, to make buy-and-hold investments in long-dated productive assets, achieving higher yields to offset longer-term risks and lower liquidity inherent in many of these assets." (ECGP, p. 8)

"Against this background, as for banks, institutional investors are obliged to meet a variety of prudential regulations and to comply with accounting standards. The new prudential rules for insurance undertakings (the Solvency II Directive) require them to hold assets to cover the nature and duration of their liabilities; holding long-term investments is aligned with the social functions of these undertakings." (ECGP, p. 8)

"Pension funds need to manage their risks in order to generate the required level of annual returns for their beneficiaries. Pension fund capital rules differ across Member States and differ from those for insurers to take into account the different risks associated with occupational pension funds and the funding resources they may access. The Commission plans to review the Institutions for Occupational Retirement Provision (IORPs) Directive." (ECGP, pp. 8-9)

"However, beyond prudential rules, a number of other structural factors affect the ability of institutional investors to play a long-term financing role. The economic downturn is likely to have a lasting impact on long-term asset allocation strategies of institutional investors by promoting more conservative investment strategies. For example, the average exposure to infrastructure assets of institutional investors remains low compared to their allocation to real estate and to actual infrastructure investment needs. In terms of risk management and diversification, institutional investors may have concerns around the large scale of long-term investment projects. The asset management functions of non-bank institutional investors may also be unaccustomed to dealing with more illiquid assets, tasks which were previously often carried out by monoline insurers which guaranteed such assets. Over time, this means that some investors may need to extend their existing skills to support their investment decisions." (ECGP, p. 9)

"There may therefore be scope to consider initiatives designed to pool financial resources and to structure financing packages according to different phases of risk. Dialogue between investors and non-financial corporates, as well as through the dissemination of good practices and case studies could help here. The Commission has also already committed to make proposals on possible forms of **long-term investment funds** (LTIF). Early indications from stakeholders suggest that a new LTIF vehicle could facilitate the raising of capital across the Union. It might help large and mid-range institutional investors to invest, for example, in a range of

[15] http://www.eib.org/attachments/general/reports/st2011en.pdf, page 5

infrastructure projects. The LTIF will help institutional investors with diversification and risk spreading. In addition, LTIF managers may bring additional expertise in how to look at the underlying transactions, or in how to select and manage long-term infrastructure projects." (ECGP, p. 9)

The degree to which institutional investors are willing and able to contribute (more) to long-term investment projects is subject to much debate. Barriers may include excessive short-term investment horizons, legislation for insurers and pension funds, unfamiliarity with less liquid asset classes, and insufficient scale to diversify into large project finance. While the professional asset management industry in Europe is estimated at EUR 13.8 trillion by EFAMA, the amounts that would be potentially available for long-term finance of relatively illiquid projects are much smaller. These types of investments are typically considered as satellite to a core portfolio of assets. The Eurosif European SRI Study 2012 finds that some large institutional investors are placing part of their assets in sustainability themed funds or infrastructure, but the amounts are so far small in relation to the overall portfolio. CPI[16] estimates that there are institutional assets worth US$ 79.8 trillion globally, and that US$ 52.8 trillion of this is "assets driven by long-term institutional obligations" (page 7). CPI breaks up available finance and needed finance into three areas covering corporate investment, project investment and pooled funds. Assuming there are no policy or investment practice constraints internal to the fund, CPI finds that corporate investments needs are met, but project finance and pooled investments are not. The largest insurance and pensions funds have the possibility to meet investment needs in project finance, but they are unlikely to become the dominant suppliers of funding. While the CPI report focuses specifically on investments in renewable energy, the methodology applies to other areas of long-term finance.

This apparent lack of scale is in part a product of the scope defined by the Commission for this paper. Long-term investments as financing productive capital assets will naturally be limited due to diversification and risk management factors beyond the effects of asset allocation produced by incentives and short-termism. This is why Eurosif would argue that institutional investors have a role to play in the promotion of long-term investing, but not perhaps in the manner envisioned by the Commission. Some institutional investors will have the capacity to support long-term projects that are historically financed by governments, given certain risk-sharing facilities and other conditions. However, it is unlikely that it will achieve the scale required to replace public finance entirely.

While institutional investments alone will not cover long-term financing needs, even if fund policy and investment constraints are removed, there are indications that it can be (slowly) increased if certain prudential rules are better formulated. The impact of Solvency II and the IORPs Directive has been mentioned in the Green Paper. Similarly, ongoing work in creating pooled investment vehicles for long-term assets may also unlock assets for investment, and increasing the savings rate by households could also provide funding.

However, diverting assets from existing sources (or even encouraging the formation of additional sources of funding) for the purpose of increasing the formation of long-term tangible assets, will not by itself bring the fundamental changes to European capital markets that are needed to restore trust, liquidity and growth.

Eurosif reiterates the point that the assets covered in this Green Paper will not attract the investment required from private funding even if institutional investors have no constraints (see CPI paper referenced above). In order to cover the range of assets that can (should) be subject to more long-term asset management in addition to the financing of long-term capital, the scope of the Commission in the long-term investing debate should not be too narrow. Limiting the scope of long-term investing to certain assets (as in this Paper) or certain products (as in the UCITS consultation) runs the risk of labelling everything outside this definition as short-term when this is clearly not the case. EFAMA argues that by limiting long-term investing to certain (illiquid) assets, one should "avoid creating the wrong impression that long-term savings' needs of retail investors can be served, or will be better served, only through investments in "long-term assets""[17] By covering all assets, and designing public policy to encourage longer investment views in asset management,

[16] Climate Policy Initiative (2013): The Challenge of Institutional Investment in Renewable Energy
[17] EFAMA Response to UCITS Consultation (2012), page 50

the Commission can achieve better results in the aim to drive assets into long-term finance and make more productive capital available in the real economy.

This can be encouraged by creating incentives for changing asset management. Asset owners need to disclose how they manage their assets and to what extent and how they incorporate long-term considerations such as ESG issues. Eurosif's European Corporate Pension Funds Study 2011 found that only 56% of funds responding have a responsible investment policy, despite 66% of respondents agreeing that having a policy is part of their fiduciary duty.[18] In addition, asset owners need to demand disclosure and incorporation of long-term strategies from their asset managers. Asset managers need to equally increase disclosure and improve incentive mechanisms. There are a range of issues that can be looked at that would encourage the investment industry to be more long-term beyond incorporating ESG issues and disclosing practice. They include:

- How derivatives are used in asset management (whether it is a legitimate hedging strategy or an uncovered bet);
- Use of short-term benchmarks for performance measurement in long-term strategies;
- Use of high-frequency trading strategies;
- Whether asset owners and managers conduct constructive engagement with companies;
- Disclosure and mitigation of conflicts of interest;
- Use of share lending and the ability to recall shares for voting at general meetings.

In order to encourage disclosure for retail funds that portray themselves as responsible, Eurosif has, with support of the European Commission, developed the European Transparency Code. This disclosure framework was recently updated to version three, and covers issues such as asset management strategy used for incorporation of ESG factors, engagement and voting, etc. The Code has been very successful, and is used by more than half the target retail funds in Europe, and is mandatory in certain Member States.

Eurosif argues that proper disclosure together with pressure from asset owners can make a significant difference in diverting more assets to longer-term strategies across entire portfolios. This Green Paper covers a small part of the investment portfolio of institutional investors, and therefore appears to represent a missed opportunity to engineer a shift the short-term culture of large parts of the asset management industry.

<u>The combined effects of regulatory reform on financial institutions</u>

"For example, if banks reduce their exposure to long-term real assets as a consequence of increasing liquidity requirements, institutional investors with long-term liabilities could fill the gap as long as the regulatory framework avoids an excessive focus on short-term volatility. However, the simultaneous introduction of liquidity requirements for different financial market players may discourage investments in less liquid assets and hence block several possible financing channels for long-term investment at the same time." (ECGP, p. 10)

No specific comment from Eurosif.

<u>Summary of Eurosif Position</u>

It is important to restore trust and confidence in banks, so that they have the capital to support businesses though short- and long-term lending activities. It is unlikely that banks will have the capacity to support large long-term financing projects, except as a facilitator.

Institutional investors can have a large impact on the shift to long-term finance in the broad sense, provided certain obstacles are addressed and asset owners are more transparent about their investment policies. Institutional investors may be able to support the formation of long-term capital, as envisioned in the Green Paper, but not in the volume required to replace public funding.

Investors (asset owners and asset managers) should be transparent about their investment policies and stewardship of funds.

[18] Study is available at http://www.eurosif.org/research/corporate-pension-funds

Section 3.2: The efficiency and effectiveness of financial markets to offer long-term financing instruments

Question 11: How could capital market financing of long-term investing be improved in Europe?

Question 12: How can capital markets help fill the equity gap in Europe? What should change in the way market-based intermediation operates to ensure that the financing can better flow to long-term investments, better support the financing of long-term investments in economically-, socially- and environmentally-sustainable growth and ensuring adequate protection for investors and consumers?

Question 13: What are the pros and cons of developing a more harmonised framework for covered bonds? What elements could compose this framework?

Question 14: How could the securitisation market in the EU be revived in order to achieve the right balance between financial stability and he need to improve maturity transformation by the financial system?

"Alongside institutional investors, well-functioning and deep capital markets and infrastructures are needed to offer a wider range of instruments to channel long-term finance. European bond markets have developed remarkably strongly over the last few decades. However, non-financial corporate bonds in Europe account still for only 15% of corporate debt compared to other economies. In practice only large corporates have an access to European bond markets, whereas most mid-caps and SMEs are barely able to tap the bond markets. European securitisation markets are also under-developed compared to other parts of the world, further limiting the range of long-term financing instruments available." (ECGP, p. 11)

"Covered bond markets have proved relatively resilient during the crisis. However, markets are fragmented along national lines... Reshaping securitisation markets could also help unlock additional sources of long-term finance... The EU as a whole has never had a true European project bond market. The Commission, together with the EIB, has begun to address this issue by implementing the Project Bond initiative, a financial market solution to address market imperfections and creditworthiness... Many also claim that the economy, businesses and investment projects need more equity, rather than more debt. Equity can be a better financing instrument for long-term, high-risk investments, as well as for investments with significant information asymmetries and moral hazard." (ECGP, pp. 10-11)

This section is specific to the subjects of financing instruments such as covered bonds, securitization, project bonds and equity. The merits of specific financing instruments is outside of Eurosif's mandate, so we welcome input from members on this issue, to the extent it is needed.

Section 3.3: Cross-cutting factors enabling long-term saving and financing

Question 15: What are the merits of the various models for a specific savings account available within the EU level? Could an EU model be designed?

Taxation

Question 16: What type of CIT reforms could improve investment conditions by removing distortions between debt and equity?

Question 17: What considerations should be taken into account for setting the right incentives at national level for long-term saving? In particular, how should tax incentives be used to encourage long-term saving in a balanced way?

Question 18: Which types of corporate tax incentives are beneficial? What measures could be used to deal with the risks of arbitrage when exemptions/incentives are granted for specific activities?

Question 19: Would deeper tax coordination in the EU support the financing of long-term investment?

Accounting Principles

Question 20: To what extent do you consider that the use of fair value accounting principles has led to short-termism in investor behaviour? What alternatives or other ways to compensate for such effects could be suggested?

Corporate governance arrangements

Question 21: What kind of incentives could help promote better long-term shareholder engagement?

Question 22: How can the mandates and incentives given to asset managers be developed to support long-term investment strategies and relationships?

Question 23: Is there a need to revisit the definition of fiduciary duty in the context of long-term financing?

Information and reporting

Question 24: To what extent can increased integration of financial and non-financial information help provide a clearer overview of a company's long-term performance, and contribute to better investment decision-making?

Question 25: Is there a need to develop specific long-term benchmarks?

Specific savings account

"Some Member States have also taken action to promote long-term saving and investment decisions by households. Auto-enrolment retirement schemes have been adopted in some countries. Others have introduced targeted savings accounts to support the financing of long-term investment projects, providing a (government) guaranteed fixed return and in some cases with certain tax concessions. The funds in these accounts are then invested in public goods such as hospitals, social housing and universities. In the longer term, it may be worth considering whether the availability of specific vehicles at the EU level could help mobilise greater longer-term savings, more directly linked to wider societal objectives." (ECGP, p. 12)

Eurosif shares the view that increasing the savings rate of citizens has merit. These savings can be used in a variety of manners to support long-term investing, but the risk of those investments must not be transferred to savers. One way to channel these savings towards long-term investment "vehicles" would be (a) to encourage disclosure about how an investment product is managed, in particular which portfolio management techniques and tools it uses and whether or not it takes into account ESG risks and (b) make these products available, on the shelf, as part of specific investment schemes. Relating to this point for instance, some Member States have introduced retirement savings products that enable investors to choose funds that incorporate ESG concerns, for example Percos in France. That in itself has attracted the attention of employees-investors into these funds ("solidarity funds") and created significant inflows in these products. This is a good example of how savings by citizens can be used to support responsible finance.

Taxation

"The structure and level of taxation can have an impact on investment and savings decisions and therefore on growth. Generally, tax systems should be designed in such a way as to distort as little as possible the economic decisions of citizens and companies, unless the taxes intend to correct externalities arising from specific and well-defined market failures:

- Tax and investment: Corporate income taxation (CIT) is one of many factors influencing decisions over levels of investment, as well as how it is financed. In particular, CIT systems in most Member States tend to favour debt over equity, creating incentives for higher leverage for firms, because interest payments are deductible, while there is generally no such relief for the return on capital...
- Tax and savings: The taxation of savings has a number of important economic implications... Many Member States have already put in place a number of incentives to increase (long-term) savings, notably with respect to pension-related savings...
- Tax incentives: Tax incentives are often considered as instruments to encourage certain types of investment; a tax subsidy might be justified when the social return to an investment is higher than the private return of the investor and therefore investment levels are below the social optimum (e.g. R&D and environmental concerns)...." (ECGP, pp. 13-14)

Tax incentives can be a powerful tool in the design of frameworks to encourage long-term investing, long-term savings, or investments in projects that have positive social and environmental externalities. Eurosif is of the opinion that tax incentives for responsible finance such as SRI funds or ESG investing is worth exploring to the extent that the initiatives are not unduly market distorting. Facilities (e.g. risk sharing tranches, tax incentives, and administrative support) that lead to a better allocation of investment resources can also be explored, for example, where the market does not sufficiently price in the societal benefits of an infrastructure project, environmental benefits from a climate change mitigation project, or social benefits from a social business. However, this must be done with care to ensure that the action does not unduly distort markets by crowding in finance and in a manner that supports the overall environmental and social objectives of the EU. In addition, investors are weary of projects that are only profitable due to tax incentives or subsidies, as policy makers can remove these later in the lifetime of the project. A stable policy environment is therefore very important for such initiatives.

Accounting Principles

"Accounting is not neutral, it shapes economic decisions: accounting standards and measures (such as the IFRS) help provide a common language between entrepreneurs, investors and public authorities, supporting confidence and safety. This means they have to reconcile different points of view: an economic interest and a financial/investor interest. Fair value accounting principles can enhance the transparency and consistency of the financial information since they show the market value of assets and liabilities and provide information on the relative financial condition of different institutions. But it may also be detrimental to stability and long-term financing horizon." (EUGP, p. 14)

Eurosif believes that some aspects of international accounting standards encourage inappropriate short-termism by investors. In addition, some aspects of investment taxation discourage ownership behaviours (i.e. by making the use of corporate debt more tax-efficient than equities). While the EU is not directly responsible for either of these areas, we would encourage the EU to use its influence to address them.

Corporate governance arrangements

"The way in which assets are managed can play an important role in long-term financing in terms of aligning the incentives of asset managers, investors and companies on long-term strategies, mitigating concerns around short-termism, speculation and agency relationships. Rules are already in place as regards fiduciary duties, conflicts of interest, remuneration, the exercise of voting rights and cost disclosures, and the provision of investment advice and portfolio management. Further action is also described in the Action Plan on European company law and corporate governance, including through possible modifications to the shareholders' rights Directive. Additional steps could be envisaged, including further assessing the way asset managers' incentives are structured to take better account of long-term considerations and requiring more transparency from asset managers on the fulfilment of their fiduciary duties. Ideas have also been advanced to encourage greater long-term shareholder engagement, which could be subject to further consideration, such as analysing the possibility of options around granting increased voting rights or dividends to long-term investors." (ECGP, p. 15)

The establishment of good corporate governance structures is a very important area to Eurosif and its members, and something that Eurosif has been pushing for a number of years. Eurosif considers a well functioning relationship between company board/management and their shareholders to be one of the best mechanisms for ensuring proper functioning of capital markets and efficient allocation of capital resources. Policy makers can promote good corporate governance through a combination of encouraging best practice arrangements and legislating minimum standards.

Concerning incentives for promoting better long-term shareholder engagement and the removal of barriers to engagement, a number of initiatives can be envisioned including:

- Asset owner and manager disclosure through shareholder stewardship codes;
- Promoting more long-term investing through increased integration of ESG issues in asset management;
- Strengthening the ability of shareholders to engage and vote, especially on a cross-border basis;
- Giving shareholders more power to influence key company oversight issues such as on director remuneration policies.

Shareholder stewardship, through a combination of constructive shareholder engagement and the voting of shares is a critical component in providing value in long-term investments. Many long-term investors understand this, and are already involved in engagement to varying degrees. However, many investors do not engage actively with the companies in which they hold shares. Eurosif's European SRI Study 2012 shows that engagement is increasing and spreading around Europe, but is practiced to varying degrees in Member States. Eurosif would advise the Commission to consider a combination of sticks and carrots when tackling the issue of engagement.

Despite the very positive effect of the Shareholders Rights Directive, there are still certain barriers to effective communication, and any barrier that creates additional cost to shareholders will reduce the incidence and effect of engagement. Eurosif therefore welcomes the Commission's Corporate Governance Action Plan and is in contact with the relevant Unit on these issues. Other barriers include rules on acting in concert in the Market Abuse Directive. These need to be clarified, and Eurosif considers that the work performed by CONSOB[19] in Italy in that matter is worth looking at. Eurosif also supports shifting more control of key decisions to shareholders, such as on remuneration. This would not only enhance control mechanisms, but also increase the incentives for investors to participate in voting decisions.

In order to incentivise better long-term shareholder engagement, the Commission should seek to promote an investment philosophy that is consistent with engagement, without seeking to influence investors with additional voting rights or preferential dividends as this can also serve to entrench pools of capital and have other adverse effects. Better long-term shareholder engagement can be encouraged by focusing on asset owners, and larger pools of capital, in order to promote long-term investment approaches that are consistent with fiduciary standards by seeking to change the focus from short-term performance numbers to quality and consistency of investment process while maintaining dedication to ESG integration and active ownership.

On the relationship between asset owners and asset managers, Eurosif agrees that the agency relationship between institutional investors (asset owners) and their asset managers can have an impact on short-termism. In the first instance, better disclosure and transparency on investment philosophy and the extent to which ESG issues are integrated into asset management can drive behaviour. In addition, contractual details that drive

[19] The Italian Securities and Exchange Authority (CONSOB), Resolution 17731, April 5 2011

asset management behaviour are important in this context such as the use of short-term benchmarks for performance measurement, the duration of mandates and the structure of performance fees.

In this regard, asset manager evaluation mechanisms need to focus on longer-term performance and the active involvement of long-term oriented investors is vital in this sense. To avoid encouraging asset managers to seek short-term benefits in managing investment contracts, Eurosif argues that there are a series of additional measures that can be taken to encourage healthy incentive structures:

- To mitigate long-term risks, asset managers could be required to report how they assess environmental, social and governance (ESG) risks in their mandates; this includes areas from investee company selection to engagement methods;
- As part of investment management contracts, asset managers should also offer ESG options (including active ownership measures) and advice for asset owners;
- Adherence to investor codes of practice on a comply-or-explain basis is another measure that can boost investor (and asset manager) transparency on how they manage investment mandates. Member States examples, such as the UK Stewardship Code could serve as a model for a pan-European code.

Furthermore the ICGN Model Mandate Initiative outline a series of additional issues that asset owners need to monitor when drafting a mandate and the EC could explore how this could feed into the EU Corporate Governance framework.[20]

Finally, Eurosif sees a need to revisit the concept of fiduciary duty in the context, not only of long-term financing, but of shareholder stewardship and incorporation of ESG considerations in asset management and selection. In support of this, Eurosif emphasises a report by UNEPFI's Asset Management workgroup that revealed the necessity of embedding ESG issues in investment management contracts and statements of investment principles. [21] The report also stressed the need for periodic reporting on ESG by asset managers and the need for longer-term assessment of asset manager performance that is better linked to long-term incentives. This already gives an indication that long-term asset management and the incorporation of ESG concerns in asset management is part of fiduciary duty, and it would be helpful if the Commission were to clarify this formally.

<u>Information and reporting</u>
"Recent analyses highlight a growing demand for disclosure of non-financial information by companies. Research suggests that companies which pro-actively manage sustainability aspects of their operations consistently have a lower cost of capital and tend to outperform their competitors over the long term. Generic requirements for disclosure might not be enough to stimulate decisions on long-term investments, so the Commission is working on developing a more robust non-financial reporting framework. Non-financial disclosure by asset managers and owners may also merit further reflection, including on how to reflect the specific risks and impacts linked to sustainability in portfolio management. Many commentators also consider that quarterly reporting creates the wrong incentives, pushing market participants to focus on very short-term results. In the review of the Transparency Directive, the Commission has proposed lifting the obligation for quarterly reporting." (ECGP, pp. 15-16)

Eurosif has long advocated the need for better non-financial disclosure by European companies, and welcomes the recent legislative proposal from the Commission to mandate disclosure of non-financial information by large companies. This is a significant step towards integrating sustainability issues into the daily management of all companies. Beyond basic disclosure, investors are encouraging companies to not only publish non-financial information in a standardised format, but also to integrate this information with financial reporting to provide a more holistic view of performance and risk. Most of the evidence, academic and other, on outperformance by companies that pro-actively manage the sustainability aspects of their organisations shows

[20] http://www.icgn.org/files/icgn_main/pdfs/drafts/mmi_consultation_31jan2011.pdf
[21] UNEPFI Fiduciary Responsibility Report, 2009, a follow up to the 2005 Freshfields report, available at: http://www.unepfi.org/fileadmin/documents/fiduciaryII.pdf

that this outperformance happens in the longer term. Thus it is evident that better integration of financial and non-financial information is especially important in the long term, and will contribute to better investment decision making.

However, for the non-financial information to be most useful to investors it must be material, comparable and forward looking, and Eurosif would encourage the Commission to support European or International disclosure frameworks that enable this information to be provided to investors. In addition certain key performance indicators (KPIs) should be adopted.

Eurosif also welcomes the Commission proposal for the removal of the obligation for quarterly financial reporting by companies. This initiative can contribute to lessening the focus on short-term financial performance of companies, and better align investor time horizons with the long-term productive outlook of the companies in which they are invested.

Eurosif research shows that more and more investors are incorporating ESG information into their investment decisions making, and that these assets have significant scale globally. This would not be the case if there was no evidence that ESG information contributes to better investment choices and therefore better allocation of capital in the economy.

Further, as mentioned above, the disclosure of how asset managers and owners reflect the specific risks and impacts linked to sustainability in portfolio management is very much supported by Eurosif. Through this disclosure, beneficiaries have better information on how responsibly their savings are being managed, and asset managers can show that they are taking their fiduciary responsibility seriously.

Section 3.4: The ease of SMEs to access bank and non-bank financing

Question 26: What further steps could be envisaged, in terms of EU regulation or other reforms, to facilitate SME access to alternative sources of finance?

Question 27: How could securitisation instruments for SMEs be designed? What are the best ways to use securitisation in order to mobilise financial intermediaries' capital for additional lending/investments to SMEs?

Question 28: Would there be merit in creating a fully separate and distinct approach for SME markets? How and by whom could a market be developed for SMEs, including for securitised products specifically designed for SMEs' financing needs?

Question 29: Would an EU regulatory framework help or hinder the development of this alternative non-bank sources of finance for SMEs? What reforms could help support their continued growth?

"The reduced availability of bank finance has already spurred policy action to promote the development of alternative, non-bank channels for SME lending. In 2011, the Commission adopted an action plan to address the financing problems faced by SMEs. Certain initiatives have already been agreed, including new EU frameworks for investment in venture capital and in social entrepreneurship funds. Some policy initiatives are also underway to facilitate SMEs' access to equity markets." (ECGP, p. 16)

But these measures may not be sufficient to address the difficulties of SMEs to access finance. Further steps could be considered, including:

- Developing venture capital. The venture capital sector suffers from lack of resources and is influenced by bank and insurance prudential regulation. Funds-of-funds could be efficient instruments to increase the volume of venture capital. A fund of guarantees for institutional investors could further reduce the constraints in this market;
- Developing dedicated markets and networks for SMEs…

- Developing new securitisation instruments for SMEs…
- Developing standards for credit scoring assessments of SMEs
- Developing or promoting other "non-traditional" sources of finance…" (ECGP, p. 17)

SME financing is not part of Eurosif's mandate, so we welcome input from members on this point, to the extent that this is needed. Eurosif supports the development of Social Investment Fund vehicles to support funding of social businesses through dedicated fund legislation package, however acknowledges that this constitutes a minor part of SMEs.

Question 30: In addition to the analysis and potential measures set out in this Green Paper, what else could contribute to the long-term financing of the European economy?

For more detail on Eurosif positions on the functioning of capital markets, including long-term investing, please refer to our policy papers, including on Corporate Governance of Listed Companies and Non-financial Reporting.

Additional input from members is welcomed for this point.

About Eurosif

EUROSIF, the European Sustainable Investment Forum, is the pan-European network whose mission is to develop sustainability through European financial markets. Eurosif works as a partnership of the national Sustainable Investment Forums (SIFs) within the EU and with the support and involvement of Member Affiliates. Recognised as the premier European forum for sustainable investment, Eurosif's Member Affiliates are drawn from leading institutional investors, asset managers, NGO's, trade unions, academic institutes and research providers, together representing assets totalling over €1 trillion. Eurosif's work includes a focus across asset classes - equity and fixed income markets, microfinance, renewable energy, property, private equity and hedge funds - all centred on the industry trends and future legislation affecting this space. The key benefits that Eurosif Affiliate Members receive include EU interfacing, SRI information and European wide initiatives that integrate Environmental, Social and Governance (ESG) issues into the financial services sector.

For the full list of Eurosif Member Affiliates, please see www.eurosif.org

Eurosif has two main roles: (1) to provide an international forum that allows members and member affiliates to work together on issues pertaining to Sustainable & Responsible Investment (SRI, see below for definition of SRI and its market size in Europe) and Corporate Governance in the EU financial services sector, and (2) to collect input from members and member affiliates and then communicate their ideas and initiatives to European policy makers, including the European Commission as well as the European Parliament. Therefore, this note is mainly driven from and by the interest and expertise of our membership.

Sustainable and Responsible Investment Definition

Eurosif continues to use the term SRI as the most readily acknowledged expression for this field and defines SRI as follows:

> *Sustainable and Responsible Investing (SRI) is a generic term covering any type of investment process that combines investors' financial objectives with their concerns about Environmental, Social and Governance (ESG) issues.*

Market Size

Eurosif published Sustainable and Responsible Investment (SRI) figures and trends in its European SRI Study 2012. This unique study highlights the scale of European SRI as well as European and National trends across fourteen countries. The Study is available for download on the Eurosif website.