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

25 June, 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]

In response, 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. Policy initiatives supporting long-term investment must therefore 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].

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.

[1] Interest Representative Register ID number: 70659452143-78
[2] See for example: http://www.oecd.org/eu/goingforgrowthandbalanceineurope.htm and http://www.imf.org/external/np/sec/pr/2013/pr13142.htm
[3] COM(2013) 150, 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.

Eurosif is therefore urging the Commission to 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?

It is worth recalling that, in the view of the Commission, "[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 therefore urges the Commission to emphasise these goals in any proposed policy action related to long-term investment and finance.

In our view, the Green Paper is not sufficiently aligned with key EU 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 cause for concern, and Eurosif would urge the Commission to use this opportunity to align policy with action to its fullest extent. When defining long-term investment, we would encourage policy makers to arrive at a common understanding of which investment activities contribute to the EU's policy goals for sustainable growth. Following this, it is important to understand how these activities can be translated into investible products, such as green and social investments, and finally assess which legislative instruments would encourage such investments.

European policy makers have acknowledged that a shift in the balance of capital allocation away from short-term to long-term perspective is needed in order to help restore confidence in the financial industry. Therefore, 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.

Growth and employment are understandably the current short-term priorities of the EU, but these goals must not compromise the long-term aims of achieving sustainable growth for future generations of citizens.

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

Summary of Eurosif Positions on Long-term investment

Long-term investing is not only a specific investment such as infrastructure, nor is it limited to a characteristic of the asset such as liquidity, nor is it constrained to long-lived capital as defined in this Consultation paper. 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 type and characteristic of the asset are not the key defining properties of long-term investing, rather the management style of those assets is.

That said, Eurosif acknowledges that some assets are more likely than others to be managed for the long-term, due to certain characteristics such as liquidity. Long-term investors will manage assets for the long term. Long-term investments may be acquired by all investors, short or long term, but are (or should be) a proportionally greater part of a long-term investor's portfolio.

In order for the European economy to benefit from more long-term productive capital, Eurosif supports the creation of specific legal frameworks to channel more investments into these assets, as this may make them more attractive to investors, especially if combined with incentives such as tax-breaks. However, it is imperative to avoid signalling to the market that assets not covered by such legislation are implicitly short term and the creation of such instruments must not overshadow the need to incentivise the broader capital markets to behave in a more long-term manner.

Long-term investors and investors in long-term assets must 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.

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 investors and savers.

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

The subsequent pages contain responses to specific questions posed in the Consultation.

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?

The supply and characteristics of long-term financing
Eurosif agrees with the Commission that the formation of long-lived capital goods can be described 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, the concept of long-term investing and financing encompasses a lot more than long-term productive assets, and Eurosif would urge the Commission to not 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 primary aim of action from legislators should be to encourage a longer-term view of finance (similar to the perspective of companies' investment decisions and time-frame of investment beneficiaries), without necessarily aiming to change the asset mix of investment portfolios. This shift to longer-term asset management can be encouraged through focusing on incentives in financial intermediaries, establishing frameworks for long-term investing and removing barriers to long-term investing.

The 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 this 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 position of Eurosif remains unchanged: 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.

[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.

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 relative allocation of capital markets. Further, increased allocation to long-term investments through public incentives must be aligned with long-term policy objectives set out by the EU.

Private Finance of Public Goods

Beyond the characteristics of LTI and the definition, Eurosif is apprehensive of 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 and produced by 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 means, 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. 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

[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."

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 expected life-time of the asset.

- The projects themselves have 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.

Eurosif Position on Long-term investing and finance

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 unlikely to be 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.

Action by policy makers to encourage long-term finance must be aligned with the long-term objectives of the EU for sustainable growth.

Eurosif Demands

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

[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.

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 structures for executives and directors of financial institutions and all listed companies.

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

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

Commercial banks
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?

National and multilateral development banks and financial incentives
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?

Institutional investors
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?

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?

The combined effects of regulatory reform on financial institutions
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?

Commercial banks

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.
- Assess the potential of other sources of financing, such as crowdfunding.

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, and not all these banks have escaped the crisis, 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, except as an intermediary. 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 local growth and employment.

Development banks

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 institutions chosen to structure projects that have positive environmental or social externalities. In addition, many have experience with public-private partnerships and use of 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. To encourage increased financing through development banks, the Commission could explore additional fund structures with low risk tranches that are suited for institutional investors.

Institutional investors

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

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

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 divides finance available and finance needed 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 inefficient asset allocation produced by incentives and short-termism. This is why Eurosif contends that institutional investors have a role to play in the promotion of long-term investing, but not perhaps in the manner or scale 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 this 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 increased if certain prudential rules are better formulated. The cumulative impact of legislation such as Solvency II and the IORPs Directive is already mentioned in the Green Paper, and addressing these may provide a more favourable environment for long-term finance. Similarly, ongoing work in the Commission on 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, the finance of long-lived productive capital, are unlikely to attract the investment required from private funding even if institutional investors have no constraints. 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,

[16] Climate Policy Initiative (2013): The Challenge of Institutional Investment in Renewable Energy

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, the Commission can achieve better outcomes in the objective 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 pension 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 equally need to 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 the initial 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 therefore 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 in the short-term culture of large parts of the asset management industry.

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

The many legislative initiatives introduced in recent years at EU and national level, as well as legislation being proposed and introduced, represents a challenge for the investment industry. It is important that policy makers consider the combined effect of legislation on the investment industry, in order to minimise cost and maximise the effect. The overarching aim of legislation should be to achieve the policy objectives set out by the EU in achieving sustainable growth.

[17] EFAMA Response to UCITS Consultation (2012), page 50

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

Summary of Eurosif Position
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 or intermediary.

Institutional investors can have a large impact on the shift to long-term finance in the broad sense (covering all assets), 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.

Institutional investors (asset owners and asset managers) should be transparent about their investment policies and stewardship of 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?

No specific comments from Eurosif.

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 accounts

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 are used and whether or not ESG risks are taken into account, 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 employee-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

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. The short-term cost of such incentives must be seen in the context of potentially providing growth and employment over the very long term. 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. In addition, it is worth noting that some aspects of investment taxation can distort ownership behaviour (for example the use of corporate debt is more tax-efficient than equities in most Member States).

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.

Corporate governance arrangements

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 still exists 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 its focus on transparency and shareholder engagement. Other barriers that should be addressed 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 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. It may also be useful to develop guidance on how different asset classes are understood to be managed in a long-term manner and report against this guidance. Transparency over key characteristics regarding long-term management, such as portfolio turnover, could be encouraged as a way to facilitate customers' choice and possible government incentives.

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 is another measure that can boost investor (and asset manager) transparency on how they manage investment mandates. Member States

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

examples, such as the UK Stewardship Code could serve as a model for a pan-European code.

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

Finally, Eurosif does see a need to revisit or at least clarify the concept of fiduciary duty in the context of both long-term financing and 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 reveals the necessity of embedding ESG issues in investment management contracts and statements of investment principles. [21] The report also stresses 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 indeed part of fiduciary duty, and it would be helpful if the Commission were to clarify this formally. Similarly, as mentioned above, it may be helpful for the EU or national governments to support the development of guidance on how different asset classes are understood to be managed in a long-term manner.

Information and reporting

Eurosif has long advocated the need for better non-financial disclosure by European companies, and we strongly support the recent legislative proposal from the Commission to mandate disclosure of non-financial information by large companies[22]. While some aspects of the proposal can be improved, our view is that the proposal serves as an appropriate baseline for improved ESG transparency and reporting to investors and other stakeholders, while avoiding imposing overtly costly requirements on companies, especially small and medium size companies. The legislation will help investors by making more relevant information available from a larger number of companies.

The legislation should also serve to incentivise a transformation of dialogue at company board level, by placing sustainability and diversity matters firmly on the strategic corporate agenda. This initiative represents a significant and historic step forward for Europe as it compels companies to improve their ESG / CSR performance, thus contributing to enhancing their overall competitiveness and creating more sustainable growth and increased employment.

Eurosif also welcomes the update to the Transparency Directive concerning 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 insufficient evidence that ESG information contributes to better investment

[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
[22] Eurosif position on the Commission proposal is available here: http://www.eurosif.org/images/stories/pdf/1/nfr_eurosif%20position%20on%20nfr%20proposal%20final.pdf

choices and therefore better allocation of capital in the economy. This is why corporate transparency on long-term ESG risks is critical.

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. In the context of this Green Paper, transparency of key characteristics regarding long-term management, such as portfolio turnover, could also be considered. Through this disclosure, beneficiaries have better information on how responsibly their savings are being managed, asset owners can show that they are taking their fiduciary responsibility seriously, and asset managers can demonstrate that they are managing assets in a manner consistent with the expectations of their clients.

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?

Eurosif considers that SMEs are a critical part of the European economy as key incubators of innovation and growth. It is therefore important for EU legislators to consider initiatives to improve the ability for SME creation and growth. Eurosif especially supports the development of Social Investment Fund vehicles to support funding of social businesses through dedicated fund legislation package, however acknowledges that this segment currently 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 of Eurosif positions on developing sustainability through financial markets and 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. These are all available on our website.

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 pan-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) 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.