

# FOSTERING INVESTMENT IN SUSTAINABLE PROJECTS

An International Financial Institution (IFI) representative stated several facts demonstrating the scale and scope of the challenge concerning climate change. There is no need to build a case for sustainable finance and environmental, social and governance (ESG) goals; the situation is clear. Europe has been at the forefront of initiatives in this direction for the last few years, including the Action Plan on Financing Sustainable Growth, A clean planet for all, and the recent comprehensive report by the Network for Greening the Financial System, A call for action. There has been progress on fostering sustainable finance, but there is the question of whether this is sufficient.

## 1.1. Sustainable Investment first requires disclosures and transparency

A policymaker stressed that disclosure is the mother of regulation. Without indicators and standardisation, it is impossible to make accurate comparisons, which precludes intelligent and transparent decision making. The regulation started as 'green only', i.e. it seeks to define what 'green' is. This initially seemed to place an excessive burden on the wrong parties, but much work has been done to get the process 'on the right track'. Now the regulation is not 'green only'; it is about the environmental and sustainability impact, and it includes a backstop. For example, the regulation makes it impossible to create solar panels using child labour or to combat climate change while significantly damaging biodiversity. Overall information must now be provided. Investee companies should also be obliged to report, but this is not included in the current regulation.

## 1.2. The financial industry considers that there is no alternative and continues to innovate

An industry representative felt that some of the most interesting successes are in the public sector. Under the Juncker Plan, several interesting projects were delivered in France. For example, 250 social housing energy efficiency retrofits were delivered.

Another industry representative felt that one of the main achievements in the past year has been that the industry now accepts that there is no alternative to sustainability.

An industry representative noted that the industry has focused on the green bond market. Bank of America for instance has issued four green bonds and one social bond totalling more than \$4 billion. Bank of America is one of the original co authors of the Green Bond Principles that were passed to the International Capital Market Association (ICMA), which has done a brilliant job of making green bonds a global phenomenon.

Beyond 'use of proceeds' green bonds, which are bonds issued by companies carrying out a particular green activity alongside less green activities, banks continue to do innovative financings such as solar lease asset backed securities, electric vehicle lease asset backed securities, green commercial mortgage asset backed securities, bonds for Chinese pure plays focused on solar, wind and other forms of renewable energy, and project bonds for renewable energy farms in the EU and other parts of the world, as illustrated.

## 1.3. The size of the challenge is enormous: there is a need to do much more

### 1.3.1. Huge investment needs

An IFI representative outlined how the Organisation for Economic Co operation and Development (OECD) has estimated a need for a €7 trillion annual investment in sustainable infrastructure until 2030 to meet the two degree target in the Paris Agreement.

An industry representative felt that Europe faces challenges about delivering the climate and energy package. Following DG ENER, the High Level Expert Group (HLEG) on this subject estimated a need for a further €180 billion per year, which will only grow given the new European Green Deal and enhanced greenhouse gas target. To achieve the Commission's long term vision to 2050, energy investment in the EU must double from €200 billion to €400 billion.

A substantial amount of this funding gap is composed of work on energy efficiency, which is hard to accomplish because these projects are largely small scale and heterogeneous.

### 1.3.2. The Juncker plan, InvestEU and the role of development finance institutions

An IFI representative noted that the European Investment Bank (EIB) has been successfully involved in the implementation of the Juncker plan. From 2020 onwards, InvestEU will replace EFSI under the new MFF (Multiannual Financial Framework), and 25% of the EU guarantee will be made available to implementing partners besides EIB, such as for example EBRD. Environmental sustainability has been the core of the European Bank for Reconstruction and Development's (EBRD) activity since its inception. The EBRD has built a substantial body of knowledge, insight and instruments to work on issues such as energy efficiency and green cities. In the run up to COP21, the EBRD set the most ambitious target in green finance of any multilateral development bank: for 40% of its total investment to occur in sustainable finance. The EBRD is on track, having invested €30 billion in more than 1,600 green projects.

However, the industry must go further into the 'nuts and bolts' of how to deliver bottom up sustainable finance projects. There has been some progress, but more action is needed. Institutions must change their existing portfolios and invest in sustainable projects.

### 1.3.3. Private sector involvement

An IFI representative considered that private sector investments will be very important for the future of sustainable finance. 80% of all investments are private, so the private sector must be at the core of the strategy.

Additionally, it will be essential to leverage local banking systems. In some countries, it is extremely difficult to channel investment and finance to SMEs and local actors, which means it is important to work through a network and reach the end consumers and stakeholders who can enact change regarding sustainability practices at a local level.

An industry representative noted that the asset management industry is increasingly investing in sustainable assets: around 20% of assets are sustainable and there are more than 2,000 sustainable finance funds.

Market participants can make significant contributions in terms of their stewardship of capital. It is possible to use ownership rights to engage with companies on their capital allocation strategies to deliver on sustainability. The industry representative's firm is currently doing pre engagement around land development with local authorities to ensure that additional public goods are included in property development. It is also essential for asset managers to 'get into the weeds' of sustainable finance to deliver additional impact.

## 2. Obstacles to securing greater sustainable finance in Europe

### 2.1. Involving both 'frontrunner' and 'followers'

A policymaker expressed his happiness with the Action Plan on Financing Sustainable Growth and the fact that the European Parliament and Council agree on the need for further work on sustainable finance. To secure more sustainable finance, it is essential to work with the 'frontrunners' in this area. Some MEPs worked hard to convince the European Parliament and the Council of the importance of this issue. MEPs worked with the 'frontrunners' from the Council – France, the Netherlands and Germany – to ensure the entire Council was on board. In Europe, there are frontrunners and followers.

There are differences between countries within the EU and differences with countries outside the EU. If Europe wants to lead, it must figure out how other countries and regions can follow it. A new European Green Deal could be very important. There are many elements in place in Europe to allow the EU to take the lead. The industry must create a credible strategy which involves both the frontrunners and these 'followers'.

The policymaker emphasised the need for a combination of different measures. The world is fragmented, and there is also a challenge regarding how to regulate access to the European market. There should be a discussion about carbon border adjustment, which will allow companies to invest in sustainability by reducing external undue pressure. There cannot be competition from the US, which has not signed up to the Paris Agreement. This is one reason why the world remains in a situation where energy taxes are low for companies and high for households while there are still subsidies on fossil fuels. Alongside work in the private sector, Europe will need public investment to tackle the remaining challenges.

A policymaker agreed that one obstacle to sustainability is that Europe must take the lead in a fragmented world. For example, the United States has not signed up to the Paris Agreement. Additionally, society is also fragmented. There is a clear need to abolish subsidies on fossil fuels but raising taxes on fossil fuels had serious consequences in France. An industry representative agreed that the protests in France are a serious matter. If the world phases out fossil fuel subsidies, there should be a high level commitment that this money is redeployed using a just transition approach, which will enable the political licence to facilitate this transition.

### 2.2. An accelerating change and a fast evolving paradigm require further political involvement

An IFI representative felt that moving insufficiently towards sustainable finance could lead to the emergence of physical and transition risk. There are questions regarding the levels of capital available in the market, the still excessive level of risk required to finance sustainable projects and the still insufficient degree to which European regulation is advanced and consistent. A policymaker expressed concern and excitement, noting several obstacles to sustainable finance. First, there is a need to address perverse public subsidies and budget spending. The world spends more on fossil fuel subsidies than health and social expenditure. Second, public procurement is a crucial lever here. The size of

public procurement varies, but it is around 10-20% of GDP. In general, communities and states buy the cheapest energy they can although it should be compulsory to buy green energy, or to follow ESG targets. Politics is the biggest area of challenge. With the right support, politicians can make progress. The policymaker explained how national interests frequently contradict environmental standards. If politics are allowed to distort this subject, the EU will end up with a perverse taxonomy with the wrong incentives. Europe must remove politics from the details.

A policymaker outlined several new risks. The challenge Europe must pay attention to is that change is accelerating, and the paradigm of the system is evolving. The reaction from the authorities must happen in parallel.

An industry representative agreed that the continuation of public subsidies for fossil fuels is the most obvious issue. A political commitment to phase out these subsidies would be highly beneficial. Additionally, there is a challenge in moving projects from research and development to deployment. As an example, there is a substantial amount of money being spent on developing carbon capture and storage, but it is unclear in whose interest a large scale roll out of this will be. A policymaker acknowledged that underachievement in projects leads to sunk investment. When there are more sunk investments, organisations lose the time or money to reinvest. There is a need for dialogue on potential exit strategies between the national governments setting the policy frameworks and the companies developing these new technologies. This would enable much more private capital to support these initiatives.

The policymaker emphasised, however, that the financial industry does have the required money. At present there is around €30 trillion in fossil dependent investments, which forms a substantial part of Europe's pension funds. Thus, the question for Europe is how to move such a large amount of money in a controlled manner. It is essential for Europe to move towards only financing sustainable investments. There must be a shift away from companies which refuse to change their policies. Within 10 years, everything should be green. The real challenge is how to accomplish this.

### 2.3. There are outstanding challenges related to Europe's regulatory framework

An IFI representative stressed the importance of destination when financing moves from brown to green investments. There is a question of transparency within the system in regard to how figures on green investment are accounted and disclosed, which means there is a need for harmonisation. Multilateral development banks such as the EIB and EBRD have sought to bring together development banks worldwide and find consensus on sustainable finance. The IFI representative informed the audience that there would be an announcement related to this at the upcoming climate summit in New York.

It is also essential to have more transparency and disclosure on the climate related risks of companies. The Task Force on Climate related Financial Disclosure and the Network for Greening the Financial System play important roles by leading central banks on these issues. Central banks are now taking climate related risks into account in their approaches to financial stability, using tools such as environmental stress testing.

Yet, both within Europe and outside it, policy frameworks have not yet been established to channel investments towards sustainable projects. Signals such as carbon pricing, incentivise the industry to shift away from unsustainable projects, but there must be a regulatory framework that incentivises private investment in sustainable finance.

## 2.4. Drivers to secure additional long term investment

An IFI representative noted the need for a long term view of projects, adding that both the EBRD and the EIB are long term lenders. This is a key factor in Europe's capacity to transform projects into being sustainable over the long term.

An industry representative felt it is important for banks to change the tenor of lending. There is a key challenge as to how money can be funnelled into equity and then remain there over the long term. There is also a contradiction between the need to incentivise short term money to be invested in projects and how long term investments are regarded in regulations. The desire to have more liquid equity in the finance sector tends to be a disincentive for long term investment.

The right balance has not yet been found at the political level. It is also essential for Europe to take a holistic approach rather than a short term vision. This is why the taxonomy is key. Europe must not treat long term investment in the same way as short term investment, even if it is riskier. It might be riskier, but it is safer for everybody in the long term.

An IFI representative noted that subsidies and the need for more equity had been mentioned. With the forthcoming InvestEU programme, there might be an opportunity to recommend a shift of emphasis towards equity tools and away from grants and subsidies. The IFI representative felt that this move has been happening for five or 10 years. In the European Union, EU structural funds are increasingly used as financial instruments. This is a positive way to use public money, because it can be reused. When public money is spent on grants or subsidies, it is expected to be lost.

Yet, when money is used as a financial instrument, there is a risk involved. In the private sector, such a loss is considered akin to an industrial accident. When there is a loss of public funds, however, the public make accusations about the misuse of money. This means it is still very difficult to use public money to take risk.

## 3. Concrete solutions

A policymaker expressed optimism on sustainable finance, because there are more opportunities than obstacles, although sustainability cannot simply become another topic in the financial sector; it must be a topic everywhere. The negative interest rate environment in Europe should drive new projects. Projects thought to be loss making now seem rather profitable. There is also increasingly more discussion of sustainability in Europe. When considering companies, sustainability is often discussed in terms of 'values versus value'. There is a change happening in terms of how corporate cultures consider the function of companies, even in the US.

### 3.1. Europe must implement a variety of measures in both the public and private sectors

An IFI representative felt that the public investment banks' role is to take a holistic approach by bringing together investment policy and technical assistance. InvestEU is an instrument which combines these dimensions. There must be high ambition on climate change action, but without an appropriate technical assistance the risk of the project might prove unacceptable to investors. In addition, InvestEU should lead to additional investment, not the crowding out of private sector investment.

### 3.2. Tax incentives could provide a vital impetus to investment in this area

A regulator suggested that there should also be tax incentives on green investments. Companies and market participants generally agree that tax incentives would facilitate sustainable investment. An industry representative noted that the tax incentives for wind and solar in the US have

led Bank of America to dedicate tens of billions of dollars to equity investments in wind and solar energy farms in the US. Subsequently, Bank of America now understands the risks involved in these projects and recognises their excellent risk/reward metrics. It was necessary to develop a definition of 'green'.

However, the new draft EU taxonomy is a watershed event in terms of regulation. The taxonomy can now help firms with financing and risk evaluation.

### 3.3. An essential aspect is that investors must be able to access high quality and comparable data on sustainability

A regulator highlighted the impact of the lack of comparable data on sustainability. To increase capital flows to sustainable investments, investors must have data that is comparable, reliable and verifiable. There are several promising legislative and standardisation initiatives. The taxonomy will enable investors to understand how different economic activities comply with environmental objectives.

The disclosure regulation will oblige market participants to disclose how ESG factors have been integrated into their activities. In addition, the amendment of the Benchmark Regulation will include two new benchmarks, the Paris aligned benchmark and the low carbon transition benchmark. Finally, while the Green Bond Standard will be advisory rather than mandatory, the criteria adopted within this standard are very positive.

There is a wide consensus on the need for regulation, but any regulation should be flexible and proportional.

Another obstacle which is factored in the Commission's action plan is the possibility of short term pressure in the market, which is why the Commission asked the European supervisory authorities (ESAs) to conduct an assessment of this risk.

An industry representative agreed on the need for higher quality, more comparable and consistent information. The disclosures agenda and the taxonomy are very important here. The taxonomy is structured in a way which enables investors to differentiate between 'green' and 'brown' activities in a quantitative way. If the taxonomy were deployed by national regulators and supervisors to make adjustments to capital requirements for 'brown' or 'green' activities, there would be an acceleration of the demand within banks for green finance products, which would be a 'game changer'.

The industry representative also felt there is in addition a need for greater engagement with and responsibility from investors in public markets. There could be a European stewardship code, which could build on the reforms in the Shareholder Rights Directive.

#### 3.3.1 Rating agencies play an important role

An IFI representative described how a prominent rating agency had stated that utility companies have been downgraded on average by three notches over the last 10 years due to a lack of visibility on their approach to the management of transition risk.

There are broad discussions about incentives, the use of public money and how to increase levels of equity, but rating agencies already embed into their assessments the kind of information that could incentivise corporates to adapt to the new paradigm. An industry representative agreed with these comments, suggesting that one rating agency has examined companies' environmental risk and established three key risk metrics: emerging technologies, shifts in demand and regulatory changes.

Another IFI representative agreed on the importance of the work of external ratings agencies, because this affects how investors apply pressure to the companies they invest in.

### **3.4. It is essential for there to be regulatory convergence within the EU and around the world regarding non-financial information**

A regulator noted the need for convergence in the existing regulatory framework. There is more regulation coming on the taxonomy, disclosure and benchmarks, but Europe also has the directive on non financial information, which was approved in 2014. Large entities have been applying this directive since 2017, but the non financial information that is being provided is not comparable, because the information can be given in very different formats.

The industry must move towards a single framework in a similar way to how the accounting world moved to IFRS. A policymaker stressed the need for alignment, suggesting that industry should embed harmonised indicators and reporting in accounting and auditing rules. This should follow the globalised approach of IFRS. However, it is also important to review global and local regulation, including MiFID, Packaged Retail and PRIIPs.