

Fostering investment in the current EU macroeconomic and geopolitical context

1. Mobilising private resources and achieving synergies with public investments in the green transition

1.1 The green and digital transitions involve a great deal of money

How to find €650 billion per year until 2030 to spend on something considered politically important? An official opened the panel by reminding the audience that the green and digital transitions involve a great deal of money. The sources of that money are public money, or private money, or a combination of the two. It is probably going to be a combination of the two.

An official noted that, although the green and digital transitions are desirable, the net present values are not positive, so it is not beneficial to invest for the private sector. The public sector needs to provide public goods, where there is not necessarily a lot of money to be made. The public sector provides infrastructure, but European rules can be seen as an obstacle. There is the question of the allocation of savings in Europe and the most efficient way of mobilising the resources needed. A large amount of cash is available. There is the economic environment. The energy crisis favours investment in sustainable energies in order to become less dependent on Russia and on fossil fuels. Producers of hydroelectric energy are making large profits at the moment and taxing them more is being considered. This is normally the signal to invest more in a particular type of technology. The big question is whether there is something wrong with the framework for the financial market.

1.2 The transition cannot be financed by public or private money alone

A public representative noted that private households are normally long-term investors. Long-term investment is needed to finance the transition towards a carbon-neutral society. Whether banks are the right investors could be questioned because their business model is for short and mid-term investments. Even more of a mixture than only public/private has to be created. What is private has to be identified, whether it is only the huge pension funds or insurance companies. How to attract normal people must be considered. The best solution is a combination of everything. The public can take some risks, as with the European Fund for Strategic Investment (EFSI). Above this risk-taking from the public, private investment can take place.

1.3 Making full use of available public resources and addressing possible supply side bottlenecks to move fast with green transition and reduce the reliance on imported energy

An official noted that Lithuania has engaged in a very ambitious green transition programme in the public

sector. The current rate of inflation in Lithuania is more than 20%.

An official stated that two-thirds of inflation in Lithuania results from energy, increasing the profitability of businesses investing in energy projects. However, the projects for the public sector are becoming more expensive. Lithuania alone will need 14 billion euros of investments until 2030 for the green transition. Previously, Lithuania used the subsidy side of the Recovery and Resilience Facility – the key instrument at the heart of NextGenerationEU –, but now Lithuania is planning to also use its loan side. In Lithuania, the focus is also on energy security.

Investing more into the green energy and acting faster might lead to more freedom and security in the coming years. The electricity price for businesses in Lithuania is one of the highest in Europe. Not investing in electricity from renewables is no longer a choice, but the banks are not providing enough funds to do that for private firms. There are also bottlenecks on the supply side, for example in relation to solar panels. If too much public funding is provided, the price of solar panels will increase, so we need a balanced solution. To maintain the country's competitiveness, it is necessary to consider the green element in taxation decisions, utilize public funds and attract private resources. Investing in renewables will increase Europe's energy security and competitiveness.

1.4 Climate remains a key driver of investment in Europe despite macroeconomic context

An industry representative confirmed that green projects are profitable and generate enough yields for investors. According to Morningstar data for the first half of 2022, there were inflows into sustainable investing of around 100 billion and outflows from conventional funds of about 1.5 times that. There is currently abundant capital in Europe because of the low-for-long interest rates. Because of the macroeconomic backdrop, some asset owners are investing more in investment grade and high yield. In addition, as an inflation hedge, there is an acceleration of an existing trend of investing in real assets. Real assets are fundamental to the transition. All the largest clients of the industry representative's organisation in Europe have signed up to the Net Zero Asset Owner initiative, which is committing to net zero by 2050.

The energy crisis has led to huge dislocations in energy prices, while asset owners still have to pay out to their beneficiaries. High-carbon companies have outperformed clean energy. Some asset owners are now also investing in high carbon-intensive companies with credible transition plans or those that are supplying materials and supplies to the transition. This can help with energy security in the short term. Public/private investments

are essential. The demand side must be considered. Capex in the traditional energy sector has fallen by 40% in recent years without a compensating investment in renewables. At the same time, demand has increased. Giving a price signal should be considered when discussing windfall taxes and price caps. Rising interest rates and higher inflation are favouring green investments in terms of debt investing and projects, but not equity investments.

1.5 The green way is the only way forward, but normal business also has to be financed

An official stated that, prior to Russia's invasion of Ukraine, the green transition was seen as restrictive, especially by some sectors. The green transition is now perceived as a way to be energy-independent from Russia and less dependent on price swings in international energy markets. Lithuania, for example, is not buying any energy resources from Russia, but prices are set at the international level. In this context, businesses perceive the green transition as an opportunity rather than a restriction.

A public representative commented that there is a concern that new bubbles will be created if all the money is invested in one aspect. There should be a mixture on a balance sheet. If everything is put into green, there will be no investments for those who have to become green and a great deal of normal business will not be covered. A baker who currently uses gas will need to buy a new oven. Money is needed to make this investment, which is not taxonomy compatible but is climate neutral.

2. Challenges and regulatory constraints for fostering green investments

2.1 Long-term investments are riskier, which creates challenges for banks

A public representative underlined that, after 2009, there was a change to a risk-based approach to regulation. The European Union never had a Lehman case, so the actions taken were effective. Even the Covid pandemic was perceived as an economic problem, not a financial world one, demonstrating that the financial systems are stable.

An official noted that it had been stated that banks are not the right institutions for engaging in long-term investment and that banks are not providing enough money for necessary investments. How banks can be encouraged to play their part in the transition should be considered.

A Central Bank official commented that these investments might be riskier than traditional corporate business as they often involve new technology and business models. Entrepreneurs often do not desire a bank loan, but rather an equity type of instrument, which is not yet provided by banks. Banks would need to take more risks. However, longer-term investments are

usually not covered by the risk appetite of banks. Representatives of banks might state that supervisors stand in the way of taking higher risks. However, the risk-orientated approach to supervision provides an important safety net also for the green and digital transitions. It would be wrong to lower the standards for risk management or credit risk to enable certain investments even though they might be politically desirable.

An official commented that there used to be a way of providing money for projects and isolating the risks, either moving it outside the balance sheet or limiting it: project finance. This is one of the contentious areas in Basel III when it comes to capital provision.

A Central Bank official stated that there are various ways to offload the risks from the balance sheet, such as securitisation. The issue of project finance is a very technical one. The Basel Accord does not put general obstacles in the way of project finance. Certain corporate constructions are not covered. There is no objection in principle to banks financing projects, but they have to do it in a way that does not weigh too much on their capital.

2.2 Banking and capital markets are too fragmented in Europe to support a sustainable investment momentum

A market expert reported that an optimal economic and financial environment has not been stabilised for supporting a sustainable investment momentum. Improving the Banking Union and the Capital Markets Union (CMU) has been discussed for many years, but the banking sector is still fragmented. There is even possibly a move backwards as national governments and national authorities have tended to ringfence their banking sectors more.

Member States with excess savings (Germany and Netherlands in particular) do not finance projects in lower per-capita- capital countries (Spain Portugal, Greece...) due to the limited financial flows in the euro area and the interest rate differential between the US and Europe. These limited cross- border capital flows in the Eurozone reflect as the lack of a genuine Banking union and integrated financial markets as well as persistent doubts of some investors in Northern Europe and about the solvency of states and companies in other countries.

In such a context, progress should be made on the recognition of the transnational banking group at the consolidated level by the EU prudential and crisis management frameworks. To this end, EU legislation should directly empower European authorities to require banks to maintain an appropriate level of capital, eligible loss-absorbing liabilities, and liquidity also at the level of each subsidiary and rely on recovery and resolution plans to make sure that losses can be properly distributed across the group and liquidity can flow where needed at times of stress.

Moreover, the power of markets should be harnessed by improving transparency and overcoming asymmetries, so investments in long-term sustainable projects can be made with confidence.

2.3 Europe benefits from a large pool of savings, which could contribute to finance these investments, provided such savings are taxed in Europe, due to lasting negative real interest rates

A Central Bank official stated that the finance needs and the cash are there but who the intermediary should be is uncertain. The capital markets will play a major role for riskier long-term investments.

A public representative noted that there are always times when major investments are needed. Especially on the European level, there is sometimes the impression that only public money is the solution. However, if money is released from the insurances, the relevant authorities are displeased because that is private money. Private investors must be encouraged to put their savings somewhere that could return higher revenues than a classic savings account.

A market expert added that most of the savings in Europe are liquid. An appropriate system to transform these savings is lacking. The Ukraine crisis and the rise of inflation has aggravated the situation, but inflation existed prior to the Ukraine and Covid crises.

There are three reasons why it is not possible to transform illiquid savings. The first is a prudential one: while there has been some progress in the Solvency II framework to recognise an infrastructure investment as an asset class, it has not gone far enough. Secondly, the risk of investing these savings is not remunerated at the correct level in Europe compared to what it exists in the US, due to the differential in interest rates. The appropriate monetary environment to encourage long-term investment is not present. The third problem is that there is still too much fragmentation in the banking sector and a lack of confidence between the savers and the states. Therefore, the review of the Stability and Growth Pact in Europe should not be delayed too much.

2.4 The interest rate differential between the US and Europe encourages savings to leave the EU and finance the rest of the world, in particular the United States

A market expert commented that a rise in interest rates will increase investing costs for states. Some states that are highly indebted will have financial difficulties. However, there must be a demonstration to the public that there is a move in this direction, even if the rates are not increased immediately to the necessary level. Such a differential poses enormous risks for the future of Europe. An attempt should also be made to attract savings from outside Europe. This would require more confidence in solidity and the sovereignty of some states and in the harmonisation of some parts of the sector. The standardisation of information and the rating of companies should be promoted further. 80% of corporates in Europe are still not rated.

A Central Bank official added that investors who seek riskier investments are going to the US. There has been a dramatic shift in Germany, where net capital exports increased tremendously from €43 billion in 2020 to €255 billion in 2021. Financial intermediation does not really work in Europe, but it works in the US. There is no strong need to go to the US to get more returns, but it is

much easier, because Europe suffers from a fragmentation and a lack of transparency.

2.5 The data challenge is huge

An industry representative reported that a recent trader survey in the equity space highlighted that the major concerns are inflation, geopolitical risks and the vulnerability of global supply chains. Environmental, social, and governance (ESG) is therefore less of a priority. The three different areas of ESG have very different levels of maturity. The most difficult area is the 'S'. Oversight of supply chains in another jurisdiction is difficult. Capital flows need to be directed towards ESG purposes, not just government spending or bank loans. ESG factors have to be included in the investment process. There is a perception that investing in ESG is for risk mitigation rather than returns. This is also why impact investment is only discussed in terms of ESG. That needs to change. To be successful, ESG needs to offer market returns in order to draw additional capital.

The first step is for all stakeholders to start using the same data. This is essential. Currently, especially in Europe, there is an ESG data jungle. It is a challenge for everyone. Companies want to report on their ESG status or progress, but smaller and mid-cap companies sometimes do not have the resources to do this. Some of the different ESG ratings methodologies diametrically oppose each other. A common standard here might help.

An official noted that green and sustainable is a political concept, not a scientific one. Depending on an individual's concept of green, different data is relevant. A political compromise is needed to solve the data problem, even though there are very few providers at the moment, so there is also a statistical problem. There is hardly any quantifiable data for the 'S'. There is the question of whether the 'S' should be excluded.

An industry representative commented that the 'S' should not be excluded, but prioritisation is a possibility. The 'E' has the dynamic and the measures currently, so should be the focus. Overall, the same data should be used. More people will then start making similar investment decisions, E investments will start to show market returns and then, potentially, the same dynamic will develop in the 'S' area.

3. Improving the framework for a sustainable financial market: the way forward

3.1 The successful implementation of NextGeneration EU, REPowerEU and Fit for 55 are essential support to long-terms

An industry representative stated that NextGenerationEU (NGEU), REPowerEU and Fit for 55 are fundamental in terms of the scale of the investment and of the signal that they give to investors of the European intent and the cohesion of policymakers. Companies and investors require certainty about in

order to price risk. If NGEU is successful, the most important aspect will be increasing the pipeline of opportunities. There is no lack of capital. There is an undersupply of projects. Canadian pension funds are investing in Europe, but there are not enough opportunities. There is currently some competition between NGEU money and national sovereign green bond issuance for the same projects. An overall policy and business environment that clearly demonstrates Europe's direction is essential.

An official emphasised that environmental regulation directly affects the yield of sustainable investments.

An industry representative added that approval mechanisms should be faster. The lack of projects is partly due to the speed of identifying them and the time before they are investable and approved.

3.2 Strengthening the CMU is fundamental to fostering investment in the green transition

An industry representative commented that CMU is still fundamental. The European Long Term Investment Fund (ELTIF) could be a game-changer in terms of pooling institutional and retail money and investing in private assets. The investment guidelines should be relatively simple and the retail distribution rules should ensure that the potential can be unlocked.

A public representative commented that, independent of the specifics of the projects being financed, effective financial markets are needed to finance a flagship project such as the twin transitions. In that context, completing the CMU and ensuring easier access to financial markets becomes even more important. Legislative initiatives in the pipeline that could boost long-term investments include the revision of the regulation governing ELTIF and the European Single Access Point (ESAP). Insurance companies are the perfect long-term investors. The ongoing Solvency II review is therefore a golden opportunity to strengthen insurance undertakings' capacity to invest long-term. Securitisation needs to be relaunched, focusing not just on simple, transparent and standardised but also on attractive.

3.3 Bring certain production lines back to Europe

A public representative noted that there is no problem with getting investments for electricity production, but the challenge for the coming winter will be heating. There is a need to go to private households. It is not huge investment in one place, but in a lot of places. Possibilities for large investors to address that have not yet been identified. More production of the whole value chain for photovoltaics should be brought back to Europe. Something like the Carbon Border Adjustment Mechanism (CBAM) is needed, otherwise the investments will not be there. There will be no private investor for the hydrogen transition in European steel production because it is not competitive. Even in the long term, there will be no revenues if the steel company goes bankrupt. If the environment is not organised, investors from within or outside Europe will not be attracted to invest in Europe any longer.

3.4 National promotional banks and institutions (NBPis) need to be treated separately from a regulatory perspective

An industry representative commented that three issues have not been discussed. The first is the expectation that yields in the future will be the same as they have been in recent years. The second is that company benefits, and dividends have never been so high and what people in the street think of such high benefits and dividends. The third is inequalities. The rise of populism in Europe is fuelled by inequality. Inequality is so high that it is putting society and European model at risk. Green (and digital) transition will only be achieved if we reduce and not increase, inequalities between winners and losers whether they are countries, regions or individuals.

Long-term investment in Europe is cruelly insufficient. This means investment with positive externalities and investments where the people in the street understand that results are for them, not only the dividends and the benefits. This is about infrastructure assets and energy. The coming winter may be difficult for some people and long term investment in energy is needed. The green transition is more needed in Europe than ever, but uncertainties are raising. Some actors are doing their job. The national promotional banks and institutions (NBPis) are transforming savings into long term investment and should be treated differently than others regulatory wide as they are doing a different job. Inflation will be, and is, the main difficulty, but when there is a high level of inflation it is better to invest in tangible assets.

An official queried how a regulation that favours tangible assets could be written.

An industry representative replied that a previous successful although not perfect approach was infrastructure as an asset class. The example set by the Juncker plan was positive due to cooperation between public and private. InvestEU is a positive outcome of the Juncker plan, even though the global level of InvestEU is not as high as could have been expected some years ago. Regulation should also treat the actors differently based on whether they are acting for the long term due to their nature. There are differences between Kreditanstalt für Wiederaufbau (KfW) and a pure private investor. It is difficult to regulate by actor, but it is a necessity.