Long Term Investment and Reindustrialisation Intergroup

#Invest4Future

MINUTES OF THE DINNER-DEBATE

"EU PRUDENTIAL REGULATION: BALANCING GROWTH ORIENTATION, THE GREEN INVESTMENT AGENDA AND STABILITY", FEBRUARY 7, 2017

On 7 February, 2017, the Long-term investment and reindustrialisation Intergroup of the European Parliament together with the European Financial Services Round Table - EFR - held a dinner debate on EU prudential regulation and incentives towards green investments.

I. List of the speakers

- Dominique RIQUET, MEP, Chair of Long-term Investment Intergroup
- Denis DUVERNE, Chairman of the Board of Directors of AXA, Vice-Chairman of the European Financial Services Round Table (EFR)
- Valdis DOMBROVSKIS, Vice-President for the Euro and Social Dialogue, also in charge of Financial Stability, Financial Services and Capital Markets Union, European Commission
- Sir Adrian MONTAGUE, Chairman of Aviva, Chair of the European Financial Services Round Table's working group on Climate Change
- Mikołaj DOWGIELEWICZ, Permanent Representative of the European Investment Bank to the European Union

II. Welcome address and keynote speeches

Dominique Riquet, MEP, Chair of Long-term Investment Intergroup, welcomed the participants and introduced the speakers. He then reminded the audience of the challenge ahead since the Paris Agreement, approved at the COP 21 in November 2015: the International Energy Agency estimates the investment required over the next twenty years at US$ 53,000 billion. In this perspective, he called for action at EU level to lower the relative cost of financing the transition towards a green economy. D. Riquet then presented two levels on which the EU can act.

First the EU can create a framework that lowers the risk profile of climate friendly infrastructure projects. The Investment Plan for Europe and the European Fund for Strategic Investments' (EFSI) guarantee mechanism in particular could be the new driver for boosting green investment across Europe. However, not enough green projects were approved during EFSI initial phase. This is why the Parliament has welcomed the proposal of the Commission on EFSI 2.0 stating that at least 40% of EFSI projects under the infrastructure and innovation window should contribute to climate action in line with the COP21 objectives.

Second, especially in a context of very limited public spending and since the EU annual budget represents only 1% the European GDP, far more can be achieved on other grounds by the EU to lower the cost of financing of the green transition. On a general level, the regulatory environment must become more stable, readable and attractive to investment.

Also the availability of financing must not be unduly hampered by prudential regulation. D. Riquet reminded the audience of the inclusion of calls to the Commission for amending Solvency II rules in the report on the EFSI regulation which he was responsible for, on the behalf of the TRAN Committee. The Commission decision to reduce the Solvency II calibration of capital charges for insurance sector exposures to qualifying infrastructure projects and European long-term investment funds was then very much welcomed.

Also, as regards banking, following a letter sent by members of the Long-Term Investment and Reindustrialisation Intergroup to Vice-President Dombrovskis, in July 2016, the Commission rightly proposed a reduction of bank capital charges for certain infrastructure investments as part of the CRR/CRD review.

D. Riquet concluded his address by addressing the Green Supporting Factor: a proposal to adopt a similar prudential approach concerning assets that support the transition towards a green economy with the current ones for infrastructure or SME assets.

Mr Denis Duverne, Chairman of the Board of Directors of AXA and Vice-Chairman of the EFR then took the floor and pledged the support of the EFR to the multiple international initiatives promoting sustainable finance, a genuine interest as banks and insurance companies are at the heart of the financing model of the European Union. He said that there is still a lot to do and that EFR sees opportunities for better and more investments in infrastructure, which includes sustainable infrastructure. Among others he quoted the FSB Task Force on Climate-related Financial Disclosures and the recently appointed High-Level Expert Group on sustainable finance to the European Commission. He gave as an important message from EFR at the dinner debate that as an industry, they support the sustainable finance agenda and that the financial sector is ready to collaborate to deliver it - because finance has a key role to play.

However, he called for systematic consideration of the interests of the European economy in initiatives to promote sustainable finance, especially on a regulatory level. The implementation of the existing regulatory agenda, the calibration of prudential requirements and the introduction of any new measure should also be assessed against the needs of the European economy and the ability of financial actors to act as long-term investors. The increasing disconnection between prudential regulation as it is currently designed, without the input of the financial industry and the reality of the market, in the context of a lack of reciprocity with other regions in the world when implementing international agreements, is something to be concerned of. He stated that the three-fold challenge of balancing growth orientation, the green investment agenda and financial stability can only be achieved through the design of a framework based on a sound economic basis and seeking alignment across every concerned policy areas from prudential to accounting and disclosure requirements. He concluded that the EFR is committed to make a constructive contribution to this ambitious but much needed programme. In that respect, he said that if the standardised approach on infrastructure proposed by the EFR were considered, it would already give policymakers and regulators the possibility to better assess the lower risk of certain investments.

Vice-President of the European Commission Valdis Dombrovskis then took the floor. Investors must anticipate the energy transition as it is in their genuine interest, he said. The COP 21 has been a turning point and reflections around the impact of the energy transition on the financial industry must be undertaken. Several initiatives have recently emerged such as the Green Digital Finance Alliance, the UN sponsored launch of the Principles for Positive Impact Finance or the G20 green finance study group. The 7.5 billion euros France has issued in green treasury bonds in January, soon after Poland, is another illustration of the current momentum for sustainable finance. But as the topic is gaining traction, several questions remain unanswered: How to mobilize private finance to amplify the energy transition while protecting the transition from “brown” to “green”? What is the most appropriate framework to encourage more long-term investments financed by private capital?

This is especially important in the context of the EU's 2030 energy and climate goals as well as the Paris Climate Agreement. On a regulatory level, two aspects can be considered such as disclosure of investor’s portfolio and the calibration of capital requirements for green investments. But if environmental criteria are key for sustainable finance, one must not dismiss the social and governance dimensions. These are part of the mandate the recently appointed High-Level Expert Group on sustainable finance has received from the Commission. It should deliver its report by the end of the year.

Vice-President Dombrovskis then gave a state of play with Green bonds. An important study on their potential, conducted for the Commission, was recently released.[1] Likely to continue to grow, the Green Bond market has mobilized investments in a variety of sectors among which[2]:

- Renewable energy (45,8%)
- Energy efficiency (19,6%)
- Low carbon transport (13,4%)
- Sustainable water (9,3%)

However, the study has revealed several barriers such as the lack of project pipelines and the lack of green bonds definition and framework.

He concluded his intervention by welcoming the active role of the European Parliament to sustainable finance and called for further contribution to green and sustainable growth.

III. Project finance and improving the regulatory environment for sustainable long-term investments and re-focusing the Juncker Plan on the Green economy

Sir Adrian Montague, Chairman of Aviva, Chair of the European EFR's working group on Climate Change then took the floor to address a defining question: why sustainability matters to the financial sector?

Simply enough, if global temperature increases above 2 degrees, then the whole economy, and the financial sector with it, will undoubtedly suffer major consequences. Maintaining global temperature increase below 2 degrees requires a fundamental disruption in our society which needs to be financed.

He quoted Mark Carney, Governor of the Bank of England and Chair of the Financial Stability Board "*We need to build a new system – one that delivers sustainable investment flows, based on both resilient market-based and robust bank-based finance. We need finance for the long term.*" He stressed that therefore we need to bring capital markets, which shape the daily reality of billions of people, onto a more sustainable footing. As such, achieving sustainability in the financial sector is both right on a moral level and on a business level. For instance, insurance companies would gain to foster sustainable growth as there are the first in line to deal with catastrophes and failures of businesses and to help their customers deal with climate change effects. But it must also pay off to be sustainable. He pointed at a report from the Economist Intelligence Unit that estimated the value that could be lost if climate change was left unchecked. The 'value at risk' was US$4.2trn—roughly on par with the total value of all the world's listed oil and gas companies or Japan's entire GDP. Issues like climate change also impact the liabilities of insurers: left unchecked, climate change will continue to affect the actuarial assumptions underpinning the insurance products that the industry provides and could render proportions of the economy uninsurable.

Sir Adrian Montague concluded his intervention by commending the recent appointment of the High-Level Expert Group in sustainable finance and gave a few thoughts as to what a sustainable finance sector would lead to:

1) Steering more capital for sustainable companies;

2) Fostering transparency and reporting;

[1] *Study on the potential of green bond finance for resource-efficient investments*, November 2016 http://ec.europa.eu/environment/enveco/pdf/potential-green-bond.pdf
[2] Ibid

3) Mobilizing capital to green assets with long term finance. This requires more collaboration between the public and the private sector and precautions to avoid crowding-out of private investors; investment into infrastructure should be encouraged, not penalised. In this context, recent changes to Solvency II and the new capital requirement rules for banks could be welcome. It is also very positive to see similar changes for infrastructure corporates. But we should ask the question: could we do more? He provided one provocative idea: given the sustainability risk some assets face, isn't it now the time to start exploring lowering the capital requirements for 'green' or 'sustainable' assets?

4) A better understanding of risks associated with climate change and the energy transition, which needs to be supported by financial regulators who understand how these risks impact the firms they regulate and supervise.
   Several projects have been set up by central banks and regulators such as the Bank of England or the European Systemic Risk Board (ESRB)[3]*.*

As for next steps, he stated that – to deliver a sustainable future for all European citizens - we need politicians who dare to focus on sustainability – not just green. He finished off with a challenge to the parliamentarians at the dinner. The European Commission has now committed to sustainable finance – creating a strategy and setting up an expert group. What could the European Parliament do to not just to support this, but to truly lead the way to make sure what the EU ends up going ahead with is good for business, for citizens and for the wider society?

Mikołaj Dowgielewicz, Permanent Representative of the European Investment Bank (EIB) to the European Union then took the floor and highlighted the commitment of the EIB to climate action. In the last five years, the EIB has provided more than EUR 90 billion for climate related investments around the world. After pioneering the first Green Bonds in 2007, the EIB remains the largest issuer with over 15 billion euros raised in total for climate projects. On another level, since 2012, the EIB has established a specific approach called "Methodologies for the Assessment of Project GHG Emissions and Emission Variations" for its annual "Carbon Footprint Exercise" report.

M. Dowgielewicz then addressed the European Fund for Strategic Investments (EFSI) in the context of public support for green investments. He warned that EFSI is a market driven process. In this context, the Parliament's target of 40% of EFSI financing in the infrastructure and innovation window to projects contributing towards COP21 climate policy objectives may impair its functioning.

He commended the close collaboration between the EIB and the National and Promotional Banks and Institutions (NPBIs) in the implementation of the Investment Plan for Europe and emphasized the merits of the European Investment Advisory Hub (EIAH) and of the investment platforms. However, he reminded that working on regulatory barriers is as much important.

Beyond EFSI, the EIB has initiated several reflections on barriers to investments. It has conducted studies on improvements in the designing Public Private Partnerships (PPPs) and on utilities. For instance, the fragmentation of management of water services across the EU (whether public/private, or different levels of governance) hinders the capacity of project promoters to raise money. The EIB has recently developed innovative financing solutions for this specific sector: hydrobonds (mini-bonds). The first example is the Viveracqua hydrobond, which pools up mini-bonds issued by eight water utilities operating in the region of Veneto, in Italy.

[3] ESRB, Too late, too sudden: Transition to a low-carbon economy and systemic risk, February 2016 https://www.esrb.europa.eu/pub/pdf/asc/Reports_ASC_6_1602.pdf?ac9580322cf36b40bb3669cc9d658243

IV. Q&A

Caio Koch Weser, Chairman of the European Climate Foundation, commended the work of the Task Force on Climate-related Financial Disclosures (TCFD) but openly wondered what course of action will be followed afterwards. He argued for mandatory disclosure of investors' portfolio in the medium to long term. Finally, he argued for the creation of an effective learning platform where actors from the financial industry and the public sector would gather for mutual learning on the effects of climate change and its articulation with their business plan.

D. Duverne argued that, for now, a voluntary approach is better than a mandatory one but remained open to make it mandatory in the medium-term (5 years). As such, a counter-example is the Article 173 (ex-48) of the French Energy Transition Law which requires institutional investors to assess climate-related risks. As there are currently difficult aspects with disclosure and scenario analysis, this requirement appeared too early.

Sir Adrian Montague joined D. Duverne in privileging a voluntary approach. He claimed that a voluntary approach is dynamic and encourages inputs, whereas a mandatory approach is static.

Douglas Flint, Group Chairman of HSBC Holdings plc, gave a few remarks on the challenges ahead. He argued that the problem does not lie in the financing of green projects but in the lack of project pipelines, mainly due to policy risks, an important barrier to investment. Also the energy transition needs to be carefully observed since an abrupt transition from carbon intensive assets' exposure to low carbon assets' would pose serious problems to the financial industry. He argued that there is virtually no chance to get a universal agreement on disclosure of portfolios since US banks would not follow it because they would fear legal liability in the absence of this provision in US law. On defining infrastructure as an asset class, Mr Flint considers it a good goal which needs a standardized set of metrics. He quoted the ongoing research taking place in China on this topic.

Sir Howard Davies, Chairman of The Royal Bank of Scotland Group plc, presented a series of regulatory barriers to long term investments such as the lack of incentives to green investments through capital requirements or market to market accounting under Solvency 2 which exposes long-term investors to short term volatility.

Neena Gill, MEP, claimed there was a little disappointment with EFSI with not enough projects to make a real difference in the world. She called for actions on capital requirements to foster investment in green projects.

Paul Tang, MEP, addressed the policy risk issue raised by Mr Flint and argued that, as true as it may be, it is inherent to a democratic society and can also be a force of change, like with the recent example of the recent revision of the Institutions for Occupational Retirement Provision (IORP II) Directive at which occasion MEPs managed to incorporate the UN-backed Principles for Responsible Investment (PRI) into the investment policy and risk management systems of IORPs.

D. Riquet concluded the dinner-debate by echoing the concerns over policy risks and their effects on predictability.