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Private funding for COVID-19 response policies and sustainable projects

European Impact Bonds/Funds: Bringing together asset managers' capital and long-term projects in the EU

EXECUTIVE SUMMARY

Europe faces historically complex challenges: Governments, and indeed societies as a whole, are committed to combat both climate change and the economic implications of COVID-19. To succeed in these objectives, public and private stakeholders need to have good ideas – and the funds to implement them.

At the same time, many institutional and retail investors believe in the opportunities to be found in reinforcing and transforming Europe's economy. The asset management industry stands ready to match investors' money with relevant projects, a task it is uniquely equipped for. However, to be as effective and efficient as possible, a sufficient number of investable projects as well as a strong and reliable framework for project investment are necessary.

We therefore propose to set up a 'European Impact Bond' scheme. These bonds would be linked to social or environmental EU projects and designed according to the evolving EU Green/Social Bond standard[1]. In a first step, grants distributed in the EU's regional and cohesion policy should be securitized. This increases the total amount available for EU project financing in the short-term substantially, thus providing a meaningful private contribution to the crisis response. The new European Impact Bond market could quickly reach several hundred billion Euro – and be expanded further by including private sector projects.

European Impact Bonds would also form the nucleus for a new 'European Impact Fund' (EIF) standard. It builds on the existing successful UCITS framework, but requires that funds invest exclusively in transferable securities from non-financial EU issuers. At least 50 percent have to be held in European Impact Bonds and at least 20 percent in securities stemming from small and mid-caps. Thereby, additional private sector funds are channelled into the European real economy. This helps to reach several core goals of the 'Capital Markets Union' (CMU). Also, an attractive investment vehicle for private and institutional investors becomes available.

[1] European Commission (2020a), "Establishment of an EU Green Bond Standard" (Link)

BACKGROUND

Investments of billions – if not trillions – of Euro are needed to transform the European economy

Recently, EU leaders have decided on a number of important legal and financial measures to spur transformative long-term projects[2]. This includes the 'European Green Deal Investment Plan', which aims to mobilise at least EUR 1 trillion over the next decade. Also, a specific recovery programme labelled "Next Generation EU" (NGEU) was drafted, consisting of additional funding of EUR 750 billion to fight the eco-

[2] For further details and explanations, please refer to
- European Commission (2020b), "The European Green Deal Investment Plan and Just Transition Mechanism explained“ (Link)
- General Secretariat of the European Council (2020), "Special meeting of the European Council (17, 18, 19, 20 and 21 July 2020) – Conclusions" (Link)

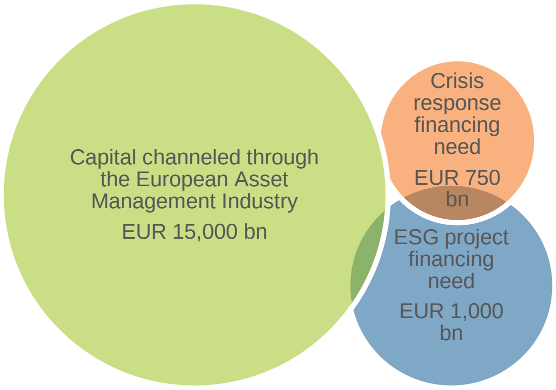
nomic downturn[3]. Responses to both challenges are to some extent overlapping, but it is clear that the overall investment need will be colossal.

In some of these projects, the private sector is intended to play some role, but it is mostly limited to either providing global financing (such as buying new EU or EIB bonds) or kick-start corporate investments via EU guarantees or co-financing. So far, the crisis response is primarily a massive public-sector effort.

EU asset managers invest EUR 15,000 billion, but hardly in transformative projects

According to the European Fund and Asset Management Association (EFAMA), investment funds domiciled in the EU managed more than EUR 15,000 billion on behalf of their customers in 2019[4]. However, resources channelled through the asset management industry are only to a small extent being tapped to raise capital for transformative projects (see fig. 1):

Fig 1: *Cohesion/ESG financing need and assets managed by the European fund industry (illustrative)*



- The 'European Long-Term Investment Fund' (ELTIF) aims at increasing "late stage growth finance of unlisted companies, infrastructure funding, and supporting sustainable investment"[5]. Yet, "initial take-up has been slow due to the legal requirements applied". There are high barriers to invest, especially for retail investors[6], eligible assets are scarce, and capital-seekers and investors often have more attractive domestic vehicles at their disposal. As a result, only about 20 ELTIFs have been set up so far.
- Another example is 'impact investing', i.e. investments "with the intention to generate positive, measurable social and environmental impact alongside a financial return"[7]. The most widespread instruments are Green Bonds, which also form a cornerstone of the "European Green Deal". Despite this, the segment is still in its infancy. According to the Eurosystem's securities holding statistics, the market value of green bonds held in the EU (excluding Sweden and Croatia) totalled EUR 72.9 billion in 2018[8]. Their growth potential is limited by the universe of available instruments: According to the European Commission, "companies' issuances of sustainable financial assets (bonds, equity) and sustainable loans currently do not meet investors' increasing interest"[9].
- Investment funds selecting their assets according to general environmental, social or governance (ESG) criteria allow better access to equity and debt financing for companies which fulfil them and/or imply shareholder engagement on the basis of sustainable principles. They stand for a small (but increasing) share of the fund market: According to Morningstar, ESG funds domiciled in the EU managed approximately EUR 1 trillion in H1, 2020[10]. However, as most of these funds provide unconditional financing to companies or governments, their immediate impact on transforming Europe's economy is limited. Also, a substantial part of their assets is invested outside the EU.

Current reform ideas to strengthen the ELTIF and impact investing segment

In order to strengthen the link between investors and investment projects, several reform proposals have been presented.

[3] The key measure are EU grants and loans for national 'Recovery and Resilience Plans', for which the European Commission borrows EUR 750 billion on financial markets
[4] EFAMA (2020), "Quarterly Statistical Release N°80" (Link), the figure excludes UK and other non-EU countries
[5] See European Union (2020), "A new Vision for Europe's capital markets. Final Report of the High Level Forum on the Capital Markets Union" (Link), p. 38
[6] ELTIFs are closed-ended, there is minimum investment of EUR 10,000, and the ELTIF may not represent more than 10% of the investors' portfolio
[7] Global Impact Investment Network (2020), "What you need to know about impact investing" (Link)
[8] Deutsche Bundesbank (2019), The sustainable finance market: a stocktake (Link)
[9] European Commission (2020c), "Consultation on the renewed sustainable finance strategy" (Link), p.25
[10] Source: Morningstar Direct

The High Level Forum on the Capital Markets Union has recently published a set of legal measures to increase the success of the ELTIF. First, barriers to investment should be reduced, for instance by allowing retail investors to exit the fund at more regular intervals. Second, investment requirements should be loosened. Third, "a favourable tax treatment of ELTIFs […] should be granted across EU jurisdictions". While some of these measures may be useful, we doubt they would substantially increase long-term investment. Instead, we fear ELTIFs could become a tax-preferential product investing in a wide range of asset classes, only loosely aligned with its initial objectives.

At the same time, the "Technical Expert Group on sustainable finance" (TEG) has developed extensive proposals to boost the European impact investing segment through an EU Green Bond Standard[11]. It is designed to provide "a voluntary standard proposed to issuers that wish to align with best practices in the market"[12]. Moreover, an extension to Social Bonds is discussed[13]. In our view, the envisioned common standards provide a good opportunity to achieve the goals set out in the "Action Plan on Financing Sustainable Growth" and strengthen the impact investing market segment.

OUR PROPOSAL

Against this background, we suggest to create a new investment vehicle that rests on the idea of impact investing. This 'European Impact Fund' (EIF) invests in long-term projects via new European Impact Bonds as well as equity and debt instruments issued by small and medium-sized EU companies. It revives the vision behind creating the ELTIF and supports an energetic COVID-19 response as well as the green transformation of Europe's economy.

A natural starting point: The European Structural and Investment Funds

A key question is how to increase the availability of impact investing assets. For us, the EU's regional and cohesion policy funds provide a unique source of projects that could be securitized and build the core of the new investment vehicle. The 'European Regional Development Fund' (ERDF) and the 'Cohesion Fund' (CF) are designed to support economic development across all EU countries in line with the EU Commission's political priorities – one of which is to fight climate change. In 2014-2020, total funding amounted to EUR 351.8 billion, a figure that will rise substantially in the 2021-2027 period. This is because regional and cohesion policy was deliberately selected as a core transmission mechanism for distributing funds in the Green Deal as well as in the Recovery Plan[14]. The two funds therefore provide a particularly good starting point, but the scheme could in principle also include projects funded through other instruments, such as the Common Agricultural Policy.

By design, the funds operate in a similar spirit as impact bonds[15]: they (1) utilise available funds for desirable projects – often ESG-related, there is (2) a clear process for project evaluation and selection, (3) the use of proceeds is tracked and (4) reporting is transparent. In the current setup, individual projects are selected, co-monitored and evaluated by 'managing authorities' in each country and/or region. The European Commission commits to co-fund the chosen projects according to several criteria, including the relative wealth of a country and project details, pays out grants and tracks project success. Table 1 describes sample projects funded in the current multiannual financial framework for illustrative purposes.

Tab. 1: *Sample projects from the current multiannual financial framework*[16]

Project description	**Fund**	**Time frame**	**EU investment (EUR mn)**
Ultra-fast broadband infrastructure for Sicily	EFRD	03/2014 - 09/2017	55.0
Cleaner waste water collection and treatment in Bucharest-Ilfov	CF	06/2016 - 06/2020	196.5
District heating system running on thermal energy to serve Florina, northern Greece	EFRD	05/2013 - 12/2019	30.4

[11] It rests upon "(i) [the] alignment of the use-of-proceeds with the EU Taxonomy; (ii) [the] content of a Green Bond Framework to be produced by the issuer; (iii) [the] required Allocation and Impact Reporting; and (iv) [the] requirements for external verification by an approved verifier"
[12] EU Technical Expert Group on Sustainable Finance (2020), EU Green Bond Standard. Usability Guide (Link)
[13] See European Commission (2020a), p.12.

[14] For instance, the 'Just Transition Fund' will invest according to cohesion policy rules and a 'REACT-EU' program will offer additional cohesion policy grants for critical sectors
[15] ICMA (2018), "Green Bond Principles. Voluntary Process Guidelines for Issuing Green Bonds" (Link)
[16] Source: European Commission

'European Impact Bonds' utilise asset managers to fund regional and cohesion policy projects

We suggest that the European Commission issues a specific project bond – either a Green or Social Bond, depending on the project – tied to each and every EU grant for a particular project that fulfils the respective criteria. These criteria should be set in accordance with the EU Green/Social Bond Standard and utilise its KPI framework and reporting templates. We suggest labelling these bonds 'European Impact Bonds'. The maturity date of an individual bond may be set according to political or financial management criteria (i.e. to maximise the acceptance/liquidity of the instrument). The bond is then auctioned, which should lead to coupon payments in line with the weighted average of EU sovereign bonds. In order to ensure acceptance of the instrument, the Commission could also decide to offer coupons above market level.

The proceeds are used to finance the respective regional and cohesion project. The outstanding amount is eventually paid from the EU budget, but since these payments are postponed compared to the Status Quo (potentially by several years), the intended amount can be used to finance other projects within or outside of the scheme in the meantime. The annex contains an illustrative example describing the framework.

This would (1) increase the total amount available for EU project financing in the short-term (thereby providing additional firepower to fight the effects of the COVID-19 crisis), and (2) at the same time make more projects investable for investors. Given the low-interest environment and the high creditworthiness of the EU as a whole, there would hardly be any additional cost for EU taxpayers.

Apart from this, the framework offers a number of additional benefits: It increases EU project funding while avoiding additional burdens for Member States' budgets (with the associated potential for conflict). Moreover, in stark contrast to the EU bonds to be issued, European Impact Bonds are directly linked to individual socially, environmentally and/or economically desirable projects. This gives them additional legitimacy and increases the likelihood for widespread acceptance. They could therefore serve as a complement or, indeed, successor of the new EU bonds. The scheme also serves as an additional path to showcase the positive impact created by the EU's regional and cohesion policy to the general public; it can strengthen the sense of community across Europe through exposure of retail investors to 'their' projects (similar to micro-finance funds).

A second step: Opening the framework for the private sector

The set-up outlined above does not necessarily represent the final stage. Since the increased assets available in the short term may not be fully absorbed by public sector projects, it would be useful to extend the scheme to the private sector – which is known to suffer from a similarly noteworthy investment backlog, for example in the area of energy efficiency, network industries, and digitalisation[17].

The assessment of eligibility could either be carried out by the managing authorities/the EU commission or by private verifiers (such as is the case for other green or social bonds). In any case, the EU should set clear standards, but allow for a diverse set of individual solutions. Then, private companies could issue European Impact Bonds under the described scheme. In our view, the core aspects should be (1) offering a streamlined issuance process (described below) and (2) providing incentives for companies to use European Impact Bonds to finance socially or environmentally relevant projects. Incentives may, for instance, include sponsoring research or corporate ratings. Of course, they can be designed to support certain market segments, such as strategically relevant sectors. This would provide another source of impact bonds, which would not be issued under pure market conditions (for instance because the issuer is too small).

Opening the framework to private projects in this fashion would imply several important steps towards the goals of the 'Capital Markets Union' (CMU)[18]:

- European Impact Bonds supplement traditional bank lending – which is feared to contract in response to the COVID-19 crisis, similar to the aftermath of the financial crisis
- They would also serve as a complement to the EIB/national promotional bank channel for financing supported by the public sector
- Cross-border investment would be facilitated by a new common standard for debt securities
- The size of EU public debt markets would be expanded, with a larger EU 'home market' helping financial services companies to remain – or become – relevant global players

[17] See for instance European Investment Bank (2019), "Investment report 2019/2020" (Link)
[18] See European Commission (2017), "Communication on the Mid-Term Review of the Capital Markets Union Action Plan" (Link)

Central assessment and issuance of European Impact Bonds

The eligibility criteria in the 2021-2027 'Multiannual Financial Framework' (MFF) are research and innovation, the digital transition, the European Green Deal agenda and the promotion of the European Pillar of Social Rights[19]. We believe this catalogue could be supplemented easily by the criteria emerging from the Green/Social Bond Standard, especially since both frameworks show substantial overlap. Then, the managing authorities could check whether a project is eligible for issuance of a European Impact Bond within their usual project assessment. They should also amend the existing tracking of the respective project by a standardised allocation and impact reporting as required by the new Green/Social Bond Standard.

Also, the proposed set-up allows for a centralised and highly streamlined issuance process: The regional/cohesion policy bonds all have the same issuer and would be standardised to a high degree; effectively, they only differ in maturity and volume (we expect all bonds to be denominated in Euro). We believe issuance could be integrated seamlessly into the EIB's operations, which then issues bonds on behalf of the European Commission. The process may also build upon ideas as set out in the European Central Banks' European Distribution of Debt Instruments (EDDI) initiative, which aims at pan-European issuance of debt instruments and contains ideas for harmonising technical standards and procedures[20]. This would be particularly useful for private issuers of Impact Bonds.

The 'European Impact Fund' (EIF) invests primarily in European Impact Bonds

We expect asset managers to be interested to offer products investing in European Impact Bonds: Given their very positive connotation and the moderate expected risk, they provide a strong incentive for certain segments of retail investors to engage with capital markets – which is another central goal of the CMU. These products would also be attractive to any institutional investor currently struggling to find sufficient investments to meet their sustainability targets, for instance.

In order to match the high standards guaranteed by the European Impact Bond framework by a similarly exclusive investment vehicle, we suggest setting up a corresponding European Impact Fund (EIF) standard. It should allow asset managers to flexibly combine impact bonds with other assets to cater different investors' risk preferences, while at the same time following clear guidelines that ensure alignment with the EU's policy goals. To this end, EIFs are required to invest according to the following rules:

(a) EIFs invest exclusively in transferable (equity or debt) securities of non-financial EU issuers

(b) EIFs invest at least 50 percent in European Impact Bonds (of public or private issuers)

(c) EIFs invest at least 20 percent in transferable securities stemming from the small and mid-cap market segment

(d) Rule (a) notwithstanding, EIFs may invest up to 10 percent in SME financing through closed-ended funds pursuant to Art. 2 (2) Commission Directive 2007/16/EC

Depending on their investment objective, EIFs also ensure that none of those investments affects the delivery of relevant environmental or social objectives, respectively.

EIFs can be rooted in the highly successful legal framework for UCITS funds (which also makes them automatically non-complex under Mifid II[21]). The proposed thresholds make sure that additional private sector capital is channelled into – and only into – the European capital market, be it in the form of equity or debt. Notably, more than 20 percent of the net asset value is reserved for investments in securities issued by small and mid-caps[22]. Since many small and medium enterprises (SME) have not issued any capital market instruments, EIFs can to some extent also engage in indirect SME financing, i.e. through units in closed-ended funds. These assets would be counted against the small and mid-cap quota.

At the same time, the investment rules give asset managers freedom in how to achieve the necessary quotas. They can choose certain public or private European Impact Bonds (depending on the underlying

[19] European Commission (2020d), Cohesion policy at the centre of a green and digital recovery" (Link)

[20] See European Central Bank (2019), "Market consultation on a potential Eurosystem initiative regarding a European mechanism for the issuance and initial distribution of debt securities in the European Union" (Link)

[21] See Art. 25(4)(a)(iv) Commission Directive 2014/65/EU

[22] The exact definition of small and mid-caps needs to ensure that the universe of eligible assets is sufficiently large and covered by investment research. The availability of high-quality investment research is a decisive factor for EIFs success, but we believe the proposals to exempt companies with an equity market capitalisation of less than EUR 1 billion from the unbundling requirement under Mifid II will already help to ensure sufficient coverage

project) and, more importantly, select other securities rather freely. This allows for a wide range of potential EIF types. Table 2 gives some illustrative examples.

Tab. 2: *Sample funds covered by the EIF framework*

Fund	Assets
Pure Green Bond Fund	■ 60% (Green) European Impact Bonds ■ 40% other EU Green Bonds (of which 20% issued by SMEs)
Investment theme (e.g. renewable energy generation or education)	■ 50% European Impact Bonds (focused on investment theme) ■ 40% equity/debt instruments of EU companies active in investment theme (of which 10% small/mid-caps) ■ 10% PE funds investing in EU SMEs from the respective sector
Balanced fund (impact bonds in FI part)	■ 50% European Impact Bonds ■ 30% EU large cap equity ■ 20% EU small/mid-cap equity

In the outlined format, EIFs can easily be incorporated into the evolving regulation on sustainable finance and qualify automatically for the status of sustainable investment under Art. 9 SFDR:

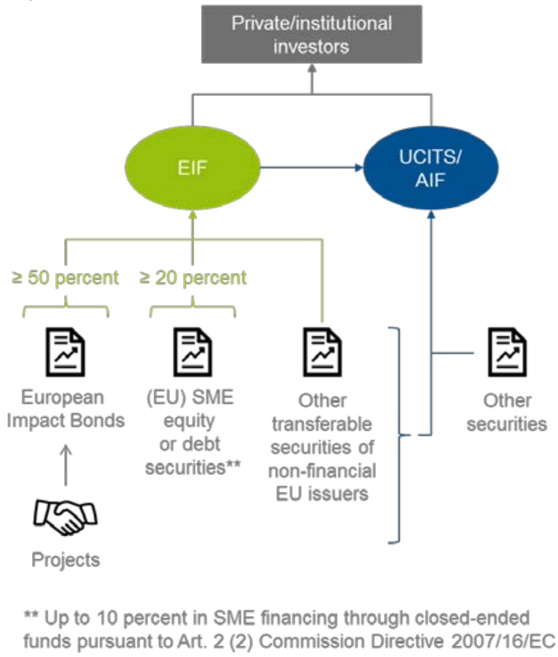
- EIFs by design have a sustainable investment objective due to the dominant share of European Impact Bonds (the exact goal they pursue should be presented to investors through a meaningful mission statement)
- The impact reporting required for impact investments is assured by the EU's standard assessment for individual projects/bonds (see above)
- All investment decisions either positively contribute to, or at least do not affect, the sustainability objectives of the product

Moreover, EIFs that focus on pursuing environmental objectives can be granted the EU Ecolabel for Financial Products[23] if they meet the relevant thresholds for environmentally sustainable investments that still need to be defined.

Of course, European Impact Bonds, as well as EIFs, may also be bought by other funds (UCITS/AIFs) to address different investor preferences in terms of risk/reward profiles and diversification. Figure 2 illustrates how EIFs would fit into the existing asset management landscape.

By introducing European Impact Funds, the segment of sustainable asset management products can be advanced considerably. Within a few years, the universe of available impact funds could grow by several hundred billion Euros. This would certainly help to develop the EU financial centres into sustainable investment hubs and support asset managers to compete effectively on a global scale.

Fig. 2: *Set-up of the European Impact Fund (illustrative)*



CONCLUSION

We believe the described European Impact Fund, resting on a European Impact Bond framework, can provide unique opportunities to policymakers, capital-seeking companies, and investors. Notably, it will (1) help to combat climate change and the economic implications of the COVID-19 pandemic, (2) advance Europe's Capital Markets Union as a source for corporate financing as well as a market place for retail investors, (3) make more social and sustainable projects investable for asset managers and grow the sustainable investment sector in the EU while (4) offering substantial political benefits vs. other policy options, e.g. through the explicit focus on use-of-proceeds.

In this way, the European Asset Management industry – and the EUR 15,000 billion it manages – can contribute effectively to addressing the current economic and political challenges.

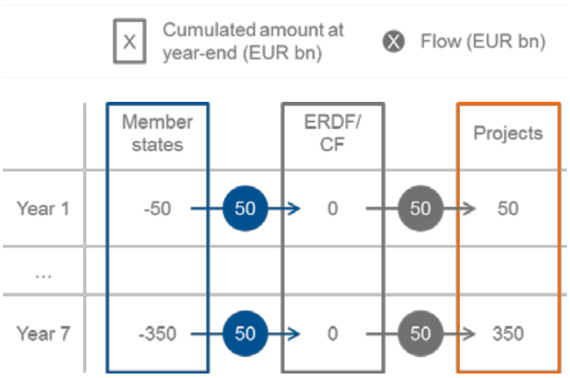
[23] See European Commission/Joint Research Centre (2020), "EU Ecolabel for Financial Products"

ANNEX

An illustrative example on European Impact Bonds

A stylised example shows how the securitization of EU policy grants would work: Consider a case where the EU receives EUR 50 billion for regional and cohesion policy projects from national budgets in every year of the 'Multiannual Financial Framework' (MFF). Without European Impact Bonds, funding is limited to this amount. We can assume for the sake of simplicity, that the EUR 50 billion are spent on one individual project per year (see fig. A1). In reality, the project size is substantially smaller while projects typically require financing over several years (see table 1). However, this would not change the general dynamics, but only technical details (which is why we abstract from it in this example).

Fig. A1: *Base case with one project financed through regional and cohesion policy per year*

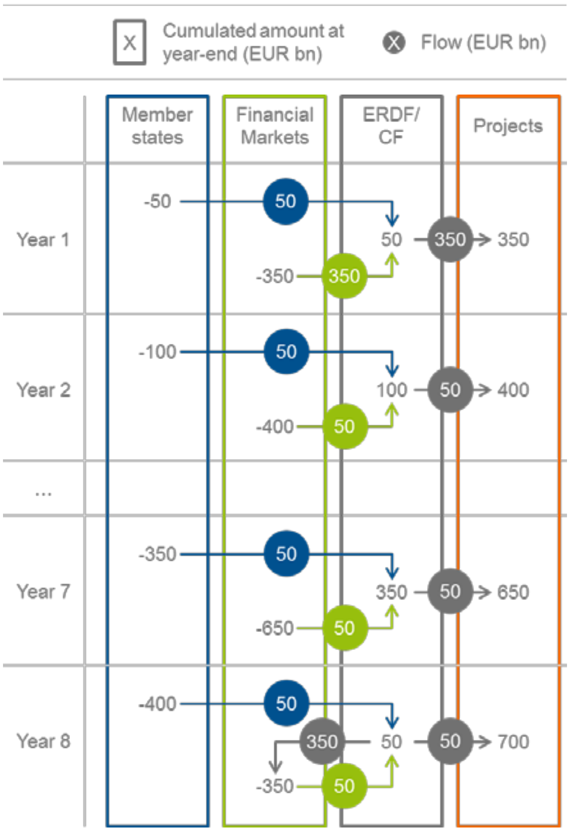


In the suggested alternative framework, the European Commission may issue seven project bonds (with a nominal amount of EUR 50 billion each) at the beginning of year one. These bonds could, for instance, mature after seven years and pay an annual coupon of zero percent[24]. Then, all seven projects could be financed in year one, i.e. total short-term investment would rise from EUR 50 billion to EUR 350 billion (see fig. A2).

In the second and subsequent years, the Commission could tackle additional EUR 50 billion projects, again financed by issuing a matching European Impact Bond maturing after seven years. As a result, total project financing over the MFF would rise from the initial EUR 350 billion to EUR 650 billion.

At the beginning of the next MFF, the first seven bonds must be paid back. To this end, the annual payments from the national budgets can be used – which have not been touched due to assuming the interest payments to be zero and abstracting from administrative costs altogether. But compared to the outstanding amount, both items should be small even under less generous assumptions (see below).

Fig. A2: *The alternative framework with additional funds sourced on financial markets*



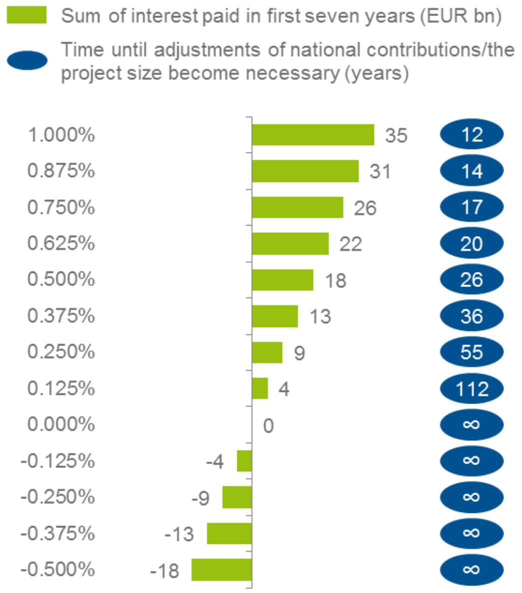
In what might be called a 'steady state', i.e. the time after the end of the (first) MFF, there is again one project per year, which is financed by issuing one new European Impact Bond. The national contributions from Member States are used to pay back the bond issued seven years before and, potentially, interest on outstanding bonds – which amount to a constant volume of EUR 350 billion.

It is certainly important to have an illustrative look at the interest rate sensitivity of the proposal. Figure A3

[24] Note that an EIB benchmark bond maturing in seven years (XS2168048564) currently offers a yield to maturity of approximately -0.5 percent (Link).

provides a rough estimation of how different coupons on European Impact Bonds would change the equation. For example, coupons of 0.5 percent would imply total interest payments of EUR 18 billion over the first seven years, i.e. 2-3 billion per year. Nevertheless, the suggested framework would not need adjustments of national contributions or the project size (or indeed the amount borrowed annually) for 26 years. Until then, the reserve from investing “only” the borrowed money in year one, suffices. The administrative cost associated with the framework is hard to estimate, but we do not expect it to alter the economics behind it substantially.

Fig. A3: *Effect of coupon size on total interest paid and scheme stability*



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