September 2022

European Union Real Assets Investment Trust

Proposal PwC for a sustainable investment regime

'Based on years of expertise, we understand the problems of the asset management industry and, as an organisation, we also understand very well the enormous sustainability challenge that lies ahead. We have tried to link the two together and build on concrete initiatives that the EU is already working on. It would be great if we could contribute with a win-win solution. Based on recent ratios, we could at least create a market opportunity of over EUR 1,000 billion in fair, green assets. That could really speed up the transition to a more sustainable Europe.'

Bart Kruijssen
partner

What's at stake?

A climate-neutral Europe by 2050. The goal of the European Green Deal sounds abstract to many. In the summer of 2022, we have seen that the rationale behind this ambitious goal is far from abstract. Forest fires and record high temperatures in Europe, crumbling glaciers in Italy, a growing shortage of sustainable, affordable housing and rising energy prices due to geopolitical instability. These are cautionary signs. The urgency for a more sustainable Europe has never been felt so strongly as it is now.

Acceleration in sustainability

Making our energy supply and built environment more sustainable, halting the loss of biodiversity and standing on our own two feet where energy security is concerned are issues that cannot be put off any longer. Action and acceleration in sustainability are necessary. This will require many hundreds of billions of euros. That money is available, partly from governments, but mainly from large institutional investors, private equity parties and in the pockets of smaller investors and smaller institutional investors.

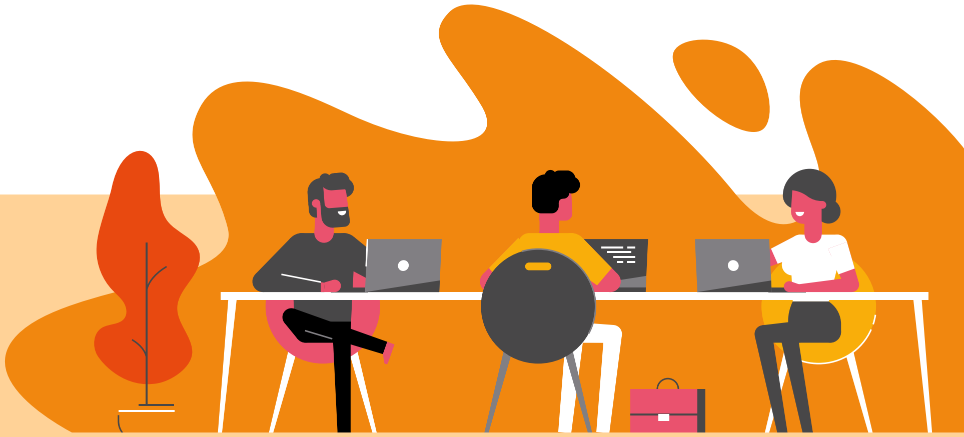
But despite the ambitions, the urgency and the availability, this money is not yet being channelled sufficiently to the projects in Europe that will put the EU on the path to achieving the goals of the European Green Deal. Projects to make buildings and infrastructure more sustainable and to help companies focused on clean technology ('cleantech') get the capital they need. This is a problem, especially now that available resources, energy and people need to be deployed as efficiently and effectively as possible to actually achieve the goals set.

Barriers

According to PwC, the reasons the available funds from large and small investors are not finding enough suitable sustainable projects to finance is because the EU capital market is fragmented and underdeveloped which prevents a leap in scale and acceleration. We refer to three underlying causes:

1. there is no uniform, leading EU funding standard;
2. there is no inclusion of small investors and of all, particularly more eastern, EU regions, and;
3. the fragmentation means there is no direction regarding the types of projects that are looking for investors.

1. *UNCTAD, World Investment Report 2022, link*
2. *United Nations Framework Convention on Climate Change, Net zero financing roadmaps, 2021, link*
3. *PwC, Green Deal Monitor #1 - Financing, 2020, link en Green Deal Monitor #6 Accelerating the Green Deal, 2021, link*
4. *Bruegel, Europe should not neglect its capital markets union, 2021, link*



1. No uniform, leading EU funding standard

Due to the lack of a single European capital market and therefore the lack of standardisation of legal, regulatory and tax rules, the EU is currently a patchwork of investment institution regimes and thus of investment funds. Regimes in individual countries are not mutually compatible. This patchwork makes the setting up of pan-EU investments (e.g. for similar investments in several EU Member States or joint investments by parties from different EU Member States) costly, unnecessarily complicated and lacking in transparency. The impact of the lack of a uniform, leading EU standard is particularly felt by the potential financiers of sustainable projects.

Example

The EU Taxonomy - as part of the European Green Deal - is under development and for many parties (still) complex to use. There are also specific property ratings, such as BREEM and CREM. However, these are difficult to compare and do not relate to the legal and tax reality and the financing situation.

2. No inclusion

There must be sufficient public support if the goals of the European Green Deal are to be achieved. After all, this is not just something for governments and institutional investors, but for all Europeans. The complexity of rules and requirements does not make this easy. In order to bring the Green Deal closer to citizens, they must be supported. Sufficient and low-threshold access of small investors and investment funds to sustainable and stable investment funds can contribute to this prerequisite support. Currently, retail investors, but also smaller pension funds and insurers, have a poor overview of and insufficient access to such investments. In large parts of the EU - particularly the more eastern regions - there are hardly local capital markets to speak of. Consequently, the market is presently not inclusive, while we require all hands on deck. This barrier must be broken down.

3. No direction

The barriers that affect the funding side also impact a barrier to scaling-up and acceleration on the receiving side, namely with regard to the type of projects that are looking for investors. As a result, there is simply too little supply of suitable 'product' to invest in. This has multiple causes. As stated, the capital market in Europe does not yet have a clear course for steering the available funds towards sustainable projects, or ESG projects (Environmental, Social, Governance). This is despite the recent introduction of, for example, the EU Taxonomy, which - in short - provides a classification of sustainable and non-sustainable projects and applications. Moreover, we need to deal with the risk of greenwashing of investments, meaning that projects in practice turn out to be less sustainable than they are presented. Also, there are not yet any large, leading parties that both the supply chain and the innovators can focus on. There are still mostly small projects and local solutions that need to be financed. While these initiatives are obviously useful, they lack the scale and impact to accelerate the transition.

In short

To achieve the necessary scale and to find the acceleration, it must become easier for large and small investors to invest in sustainable projects at the EU level. It must also be possible for all parties in the EU to find capital at a good price.

Flywheel

If we manage to remove the aforementioned barriers, we also create a flywheel effect. A standard regime - as we see worldwide with REIT regimes - inspires confidence. A trusted standard has a magnet effect. By bringing all parties together and cooperating, the transition can be accelerated because the market will function better and therefore more efficiently. The demand for finance will be better matched to the supply of money, leading to an acceleration. And because of the magnet effect, knowledge and innovation will interface even more with other knowledge and innovation, which will lead to even greater acceleration.

Together, we will give a boost to the flywheel of progress and achieve a climate-neutral EU by 2050.

5 *A REIT is an organisation that owns, operates or finances real estate from which it generates income. It usually brings together capital from many investors. This capital is then used to invest in real estate such as office buildings, apartment complexes, shopping centres and hotels. The investors do not have to deal with issues such as leases and maintenance. What most REITs have in common is a kind of tax transparency: it is not the REIT itself that is taxed for the said income, but the investors. For further details, see: Nareit, What's a REIT?, 2022, link*

EU-RAIT: a pan-EU Investment Trust regime

According to PwC, a solution to the problem outlined above lies in the introduction of a pan-EU Investment Trust regime: the European Union Real Assets Investment Trust (EU-RAIT). This is a set of pan-EU legal, regulatory and tax agreements. These agreements will ensure that the investment funds, which will be set up under this new regime, can invest extensively in sustainable projects in the European Union and that the associated ground rules are clear and uniform for all. We outline the most important characteristics and requirements of such a regime below.

A pan-EU regime creates a uniform and leading standard within the European Union that eliminates the need to fathom all the current national rules (and the differences between them). This can save all parties involved a lot of time and money when, for example, an asset manager sets up international investment funds, but also during due diligence when purchasing a portfolio of investments or when investing in such a fund. A simpler solution is also easier to explain to the public.

A pan-EU investment trust regime also requires standardised tax rules, which are identical in all EU countries. On the one hand, a pan-EU regime can create incentives for investment institutions to be offered 'product' and, on the other hand, 'compensation' is given for the (higher) cost of complying with the regime, for instance through a reduced single profit tax for taxpayers based on IFRS rules. Such a step creates an incentive as we see more often for sustainable behaviour. At present, there are also facilitated tax regimes in the Netherlands and other countries, where certain innovative and sustainable 'behaviour' is rewarded. A pan-EU regime would complement these Member State regimes.

Such a regime must also make it possible for small investors to invest in sustainable European projects. Inclusion in other words. This applies to the investor who invests a small amount per month in his or her portfolio, but also to the smaller pension funds and insurers who, in the current circumstances, often lose out to the large funds with great financial strength. In addition, the capital market (supply and demand) of Central and South-Eastern Europe must also be opened up and be able to compete on an equal footing with that of Western Europe. All investors must benefit from profitable, sustainable investments in investment funds, while all capital seekers must benefit from low financing costs due to the abundance of money. This applies to both the public and private spheres. A mechanism that allows the participation of all investors is indispensable for the creation of a truly inclusive - and thus public support enhancing - regime.

Finally, the regime provides guidance by integrating existing EU regulations - such as the EU Taxonomy and Sustainable Finance Disclosure Regulation (SFRD) - into the regime. Anyone wishing to invest via a fund under this regime must ensure that it complies with these regulations. In concrete terms, this means that, for example, real estate projects are in line with the requirements of the EU Taxonomy with respect to construction, renovation, financing and operation. This is an efficient way to meet the objective of the EU, the project's immediate environment and its investors and it is easier to check whether those involved comply with the agreed rules.

'I don't invest in an industry I don't support. But choosing truly sustainable equities I think is difficult, as a small, private investor you never know for sure'

Small investor during focus group survey

The regime also provides direction by defining what may be invested in by the fund: real estate, infrastructure and clean technology. 'Real assets', as they are called. The reason for limiting the regime to real assets is that the related sectors require very large investments within the framework of the European Green Deal and real assets are also considered a stable investment product, certainly in times of high inflation.

New and existing assets

Under an EU-RAIT regime, a distinction must be made between new assets and existing assets and between assets that do or do not intrinsically qualify as ESG-proof. In the case of new assets, such as hydrogen infrastructure and schools, value is added to society, with part of the value having a green and/or social character, in addition to the financial value. This is not the case for investments in existing assets. The focus for existing assets will therefore have to be on making them more sustainable or keeping them sustainable, such as when insulating existing homes and making them gas-free. Non-ESG-proof assets can also qualify, but only if, for example, they comply with a high sustainability certification. For each asset category, ESG criteria can be examined at the time of construction or purchase and when a particular asset is in use.

Examples of real estate: offices, industrial, retail, hotels and public buildings such as schools, libraries, courts. Examples of infrastructure: roads, rail and stations, ports, power stations. Examples of clean technology assets: solar power generators, wind power turbines, algae farms, cogeneration plants.

6. *Investopedia, Real asset, 2021, link*

Connection to current initiatives

A good idea never originates in one place. In the current and upcoming European plans and legislation, we may already find several starting points for the realisation of a pan-EU investment institutions regime.

Fit for 55

Under the leadership of European Commissioner Frans Timmermans, the European Commission is working on the realisation of the Fit for 55 package. In this package, the goals of the European Green Deal have been translated into legislation and regulations, including for achieving the goals on energy efficiency, renewable energy, CO2 emission standards for cars and the infrastructure for alternative fuels. A pan-EU investment institutions regime therefore finds its direction in the legislation from the Fit for 55 package.

European long-term investment funds (ELTIFs)

In May 2022, the European Commission set out its position on the future of European long-term investment funds (ELTIFs); a framework of rules in place since 2015 for eligible assets and investments, diversification and portfolio composition, limits on leverage and on leverage trading. ELTIFs are the only long-term investment institutions that can be traded across borders to professional and non-professional investors. However, since the legislation was introduced, only in four Member States (France, Italy, Luxembourg and Spain) have ELTIFs been launched and on a limited scale.

We believe that the EU-RAIT proposed above would be a much-improved version of the ELTIFs, including the Green ELTIF, which is under development. In our view, the ELTIF is too theoretical, heavily regulated and does not sufficiently solve problems faced by asset managers. As such, it does not accelerate the European Green Deal and addresses the private equity market, a market to which the small investor does not have access (not inclusive). The EU-RAIT provides an incentive (a European uniform and leading standard, not only on a regulatory but also on a tax-legal level), which the asset managers will act on. They will set up exchange-traded funds, the entire focus of which is ESG-proof and which they would not be led to do without an incentive.

Capital Markets Union (CMU)

The Capital Markets Union (CMU) is a plan by the European Commission to create a single market for capital. It aims to unlock money - investments and savings - across the EU, so that consumers, investors, and businesses can benefit from it, no matter where they are based. With a European capital market, the Commission hopes that businesses will have a wider choice of financing at lower cost, to support the economic recovery from the Covid-19 pandemic and to create a more inclusive and resilient economy. The EU-RAIT would be one of the promising initiatives towards a more mature European capital market and therefore fits well within the CMU plan.

Business in Europe: Framework for Income Taxation (BEFIT)

By 2023, the European Commission will present a new framework for company taxation in the EU that will reduce administrative burdens, remove tax obstacles and create a more business-friendly environment in the single market. Business in Europe: Framework for Income Taxation (or BEFIT) will contain a single regulatory framework for company taxation in the EU, providing for a fairer distribution of taxing rights between Member States. BEFIT is expected by the Commission to reduce red tape, lower compliance costs, minimise the scope for tax evasion and support employment and investment in the EU single market.

Under the BEFIT banner, the expectedly complex tax harmonisation required to set up an EU-RAIT could be piloted. This would provide lessons for the further implementation of BEFIT.

Use cases The potential application of an EU-RAIT can well be illustrated by several fictive use cases:

A construction company/asset manager investing in social assets

The asset management arm of a German/Austrian construction company (GAM) is considering setting up a fund for affordable housing (Mid rent) that will invest in 25 selected large cities in Western and Central Europe. It is a new investment line for GAM. In Europe, affordable housing is a growing asset class, as is housing in general. It is difficult for any player to find projects. GAM generally only targets medium to large European and US pension funds as investors, most of which are exempt from taxes in their home countries. The investment strategy consists of turnkey, fully ESG-proof projects and of operational portfolios that require relatively small investments to make them ESG-proof. The target internal rate of return (IRR) is 8-10%, which is at the same level of return - or even higher on a risk-adjusted basis - as other residential funds, despite the ESG-proof stamp. GAM's adviser suggests using an EU RAIT because it offers flexibility and a regulatory and tax regime that is as neutral as possible for investors, i.e. it does not create significant (additional) burdens on top of the rules in their country of residence, and is competitive in the acquisition market.

An Irish bus driver wants to invest in solar panels

A bus driver from Cork considers several matters he sees happening every day. He saves a few euros every week for his children, who are both still at nursery school. As he drives around, he sees solar panels sprouting up like mushrooms in his city, but at the same time he does not believe that the Irish climate is the best context for this investment. He has chosen a huge Greek solar panel project to spend his savings on. Although he has never been to Greece, he has trust in the strong involvement of local residents for this investment. He is convinced that if the local community wants this project to flourish his investment will pay off.

An investment manager invests in old office buildings

A European-based US investment manager has its eye on old office buildings for renovation or conversion into student accommodation. Most opportunities are in southern and eastern European capitals and western European secondary and tertiary cities. Their main competitive advantage is their strong track record in implementing their plans, which often acts as a catalyst for a broader renewal of urban areas, as well as their quick and solid acquisition process. These elements inspire trust with both authorities and sellers. The investment manager is interested in the EU-RAIT because it offers clearly defined ESG parameters to be met, which in turn are essential for their institutional investors. Moreover, the tax and regulatory aspects of the regime provide them with the conditions to set up an assembly line in which they transform 'bad' ESG assets into excellent ESG-performing assets. The whole process between acquisition and exit takes 24 to a maximum of 30 months.

A new combination invests in infrastructure assets

A new combination of a British asset manager, a Benelux energy multinational and a Scandinavian turbine engineering company is doubling the number of new wind farms in the North Sea. They expect to win a dozen more projects in the coming years with their new competitive position. They usually have a wide range of investors: from wealthy investors to investment companies and from funds to energy companies. They are setting up their new investment line and have been advised that the EU-RAIT provides them with an ESG platform that will attract new investors. The EU-RAIT offers a solid regulatory and tax system that can be easily understood by investors and all other stakeholders.

A Czech dentist invests her savings

Private savings are better invested carefully, because inflation causes the value of bank accounts to fall. The dentist has previously tried crypto investments and the stock market, but finds that both markets are too focused on experts and professionals. She recently downloaded the new easy investment app EU-RAIT onto her smartphone. The dentist has chosen half a dozen investment funds, based on diversification of geographies and the biographies of their various management teams. She is very enthusiastic and tells her football team about it.

Balearic public-private partnership

The government of the semi-autonomous Balearic Islands is keen to invest in electric aviation. It fears a further increase in flight shame since it is mainly dependent on tourism. Electric aviation would also make short-haul, regional aviation and thus 'island hopping' more interesting. The Balearic Islands have embraced sustainable tourism. They will be investing in charging stations and other facilities at six runways on the islands. Through an EU-RAIT, the government is channelling both private money and attention to its green plans.

A Croatian engineering firm goes European

A Croatian engineering firm mastered a modular approach to housing units years ago. It has grown into a small construction company at the local level. The Croatian capital market is still in its infancy. Although the company has considered issuing a green bond to attract Western European capital, its size is too small to make this happen. A joint venture with a large Italian construction company is making a difference. They have found each other through the network surrounding the EU-RAIT market. The joint venture will set up an EU-RAIT in the coming months with the aim of being operational in half a dozen countries.

Co-creation

A good idea is rarely the result of the thinking of one person or one party. That is why PwC believes in the means of co-creation to set up and develop the plan of a pan-EU Investment Trust regime.

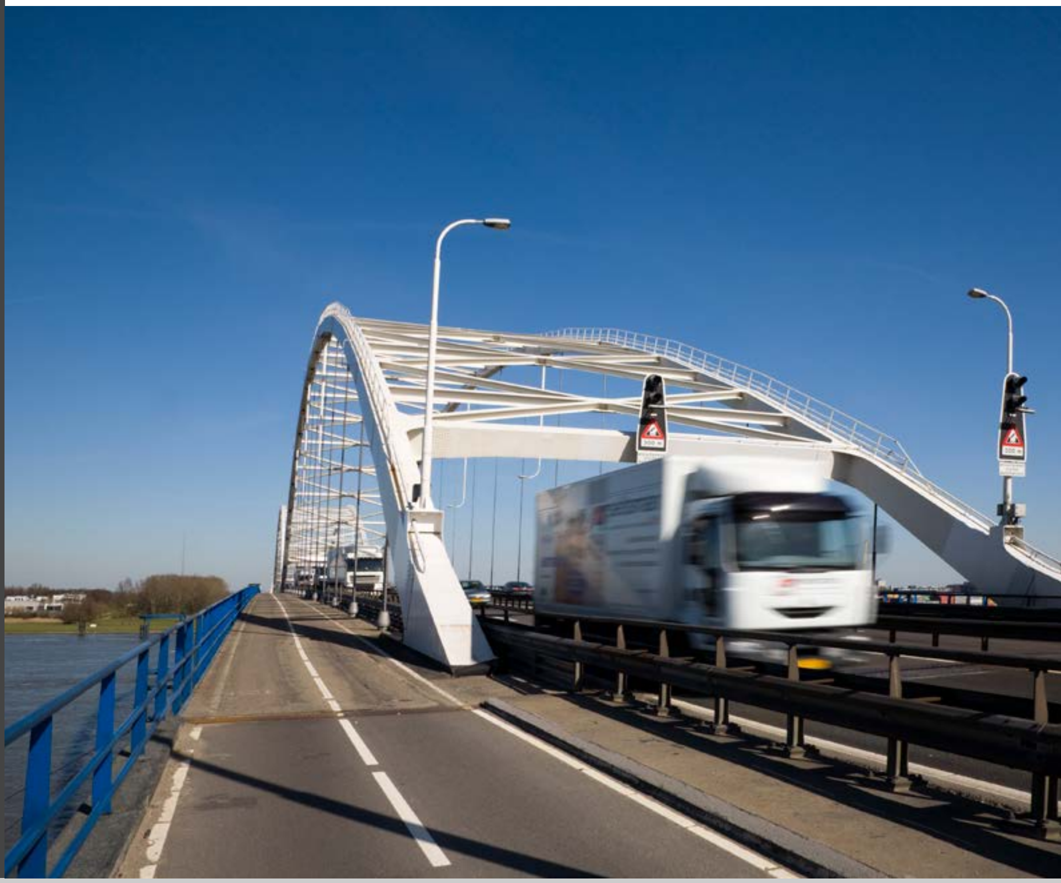
To date, we have already discussed the plan with many external parties and incorporated their input: institutional investors, insurers, small investors, scientists, real estate experts, infrastructure consultants, cleantech experts, politicians and many others.

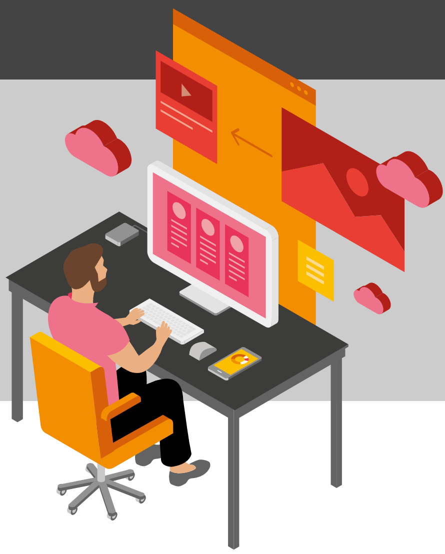
We invite everyone who wants to contribute to the further development of our plan to join us. By sharing knowledge once or getting involved long-term. Every form of involvement is welcome. Are you interested? Then please get in touch with one of the persons below.

Follow-up steps

In other words, we are not done yet. Far from it. In the period ahead, we will focus on fleshing out our plan further. We will do this by investigating more precisely how an EU-RAIT can fit into existing or upcoming laws and regulations and, therefore, to what extent additions to laws and regulations are necessary. And we are doing it by getting a clearer picture of the macro-economic opportunities and challenges of introducing an EU-RAIT.

We hope to take steps in this regard so that the EU Member States, the European Parliament and the European Commission will eventually decide to introduce a similar EU-RAIT. By doing some of the groundwork, PwC is trying to contribute to a fairer and more sustainable world.





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