The Rt Hon Greg Hands MP
Department for Business, Energy & Industrial Strategy (BEIS)
1 Victoria Street
London
SW1H 0ET

By email: evidence.gfs@beis.gov.uk

Date: 22 June 2022

Dear Mr Hands

Update to Green Finance Strategy – Call for Evidence

We are writing on behalf of the British Private Equity and Venture Capital Association, which is the industry body and public policy advocate for the private equity and venture capital industry in the UK. With a membership of over 750 firms, we represent the vast majority of all UK-based private equity and venture capital firms, as well as their professional advisers and investors. Between 2016 and 2020, BVCA members invested over £47bn into around 3,500 UK businesses, in sectors across the UK economy ranging from heavy infrastructure to emerging technology. Companies backed by private equity and venture capital currently employ over 2m people in the UK and 90% of the businesses our members invest in are small and medium-sized businesses.

Greening Finance and Financing Green

The BVCA welcomes the opportunity to comment on the Government's call for evidence on its update to the UK's Green Finance Strategy. We support the Government's efforts to make the UK's the world's first net zero financial centre through its Net Zero Strategy and Greening Finance Roadmap. Our feedback relates principally to Greening Finance and the financial services aspects of the Green Finance Strategy, and we offer recommendations on how the Government can ensure that current and future financial risks and opportunities from climate and environmental factors are effectively integrated into mainstream financial decision-making.

Furthermore, as significant minority or majority investors in UK companies, we also support the Financing Green agenda and encourage the Government to maintain its objective of mobilising and accelerating flows of private finance into key clean growth and environmental sectors. Investing in the development of green skills, growing the pipeline of green investments and developing effective sectoral policies in the real economy are vital, and we support many of the recommendations made by the CBI in this regard.

Key recommendations

Our key recommendations are that the UK's approach to green finance should:

1. **Foster buy-in from SMEs and entrepreneurs and facilitate effective investor decision-making** by ensuring that climate and environmental regulation is proportionate, focusses on material sustainability issues and eschews box-ticking, whilst recognising in policy and rules the concept of transition or "brown-to-green" investments that drive real sustainable change.

2. **Maintain the UK's reputation for sophisticated, effective green finance policy** by ensuring co-ordinated policymaking, timely implementation and effective and proportionate sequencing of the various pieces of the green finance puzzle that are being developed across Government and by regulators.

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3. **Support the UK's private capital industry to continue out-performing on the global stage** by ensuring that UK financial services sustainability regulation remains close to international standards whilst tailoring certain aspects of the rules to ensure they work effectively for the UK's private capital industry.

The opportunity offered by the UK's leading private capital industry

The UK's private capital industry has a leading role to play in global efforts to eliminate the causes and combat the effects of climate change. As either majority or significant minority owners, principally of unlisted, fast-growing SMEs, private capital funds managed by BVCA member firms are well-placed to drive transition in areas of the UK and global economies that public markets cannot reach.

- Private capital backs innovation that creates the technology we need to fight climate change: Our members are finding and helping to grow innovative UK and global private businesses that offer solutions to the world's climate problems. The funds they manage invest in portfolio companies that are, for example, commercialising electric motors that protect rare earth minerals, making hydrogen power more efficient and available for consumer use, and developing the technology for sustainable electric air travel. To understand our industry's critical role in developing and growing the intellectual property that is indispensable for achieving net zero, please see our *Ten Steps to Net Zero* publication, which gathers a sample of ten exciting businesses built on climate-related innovations that private capital firms are currently nurturing and scaling towards national and global application.

- Private capital grows the leading UK businesses of tomorrow, and can green them today: As well as funding climate solutions, private capital also has a responsibility to create and grow companies across the UK economy, from the ground up, which have climate and environmental considerations at their heart. A company with one founder and a reliance on energy-intensive technology may not have the best environmental credentials today, but private capital firms are ideally-placed to change this by embedding climate and environmental considerations into the business's systems and culture as it grows. In this way, private capital can support the world-leading UK businesses of tomorrow to help realise the UK's climate and environmental ambitions and prepare for a low carbon future, today.

- Private capital firms present a real "brown-to-green" opportunity because of their role in driving down emissions across the real economy: Our members' funds are invested in over *5,000 UK companies*, 90% of which are fast-growing SMEs, and in relation to which our members often wield significant influence as a result of large minority or majority ownership and board positions. Private capital firms are well-placed to actively support these businesses (which are typically below the threshold of much of the UK's evolving sustainability regulation) over the long-term to reduce their greenhouse gas emissions. This may be via funding investment in new infrastructure or technology, restructuring the business to optimise for realisation of green commercial and finance opportunities, or creating the trajectory for certain assets to be decommissioned. Given that SMEs account for around 50% of UK business emissions[1], this activity is key to the UK meeting its green objectives, and must be supported by Government policy across departments and amongst regulators.

Support private capital's role in transition

For the Government to capture this opportunity for the real economy and decisively reinforce the UK's position as a global hub for green finance, it needs to ensure that the UK's green finance rules effectively distinguish between mainstream investment in large listed companies on the one hand and private capital funds investing in the pool of unlisted SMEs from which the UK's future large listed businesses will emerge, on the other.

[1] Smaller businesses and the transition to net zero (british-business-bank.co.uk)

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Effective sustainability regulation covering the financing of both types of business is critical to the UK's climate ambitions, but the success of the various legal and regulatory frameworks for private capital funds and the largely unlisted companies they invest in depends on the Government and regulators taking into account certain distinguishing features of the private capital industry:

- Different assets – the Government should help foster buy-in from unlisted SMEs by focussing on proportionality and the particular green issues that are material to different companies' activities

  Despite falling largely outside the direct scope of much of the existing and incoming climate-related regulation in various jurisdictions, the unlisted SME market forms an important piece of the green finance puzzle, not least because SMEs account for around half of UK business emissions[2]. The British Business Bank estimates that 76% of UK SMEs have yet to implement a decarbonisation strategy. Private capital firms have an important role to play in reducing this figure because our industry invests extensively across the unlisted SME market, with SMEs constituting 90% of BVCA members firms' portfolio companies, and because the private capital ownership model typically gives our members varying degrees of influence (and in some cases 'control' (in the legal sense)) over investee company boards. Private fund managers often engage daily with portfolio company management teams, sit on boards and can influence, to some extent, climate discussions. The private capital industry therefore (a) understands unlisted SMEs and (b) is well-placed to help drive emissions reductions amongst them.

  Private capital funds also often invest in entrepreneurs with great ideas and SMEs with promising growth trajectories at a relatively early stage. This gives private capital firms the opportunity to help embed in those businesses, earlier on in their development, the culture and systems required to achieve net zero and other environmental outcomes. This can be far less challenging and costly than 'retro-fitting' the necessary changes into larger, longer-established companies.

  Regulation has also not yet effectively rewarded or accommodated the positive potential impact on environmental goals of strategies that aim to support companies in their transition (i.e. "brown-to-green" assets). Private capital firms are well-placed to improve portfolio companies' green performance over time, given firms often have significant influence over boards and their strategy of making operational improvements more generally in order to increase their investors' returns on exit. SDR and the UK's Green Finance Strategy more broadly must recognise the importance and policy value not only of investment in assets that are already green, but also the importance of investment strategies that will create more green assets.

  It is also important that regulation fully recognises the data limitations faced by SMEs, whose entry into a private capital fund portfolio will often represent their first encounter with sustainability-related reporting requirements. The fast-growing, unlisted SMEs that constitute the bulk of our members' funds' portfolios typically have limited resources with which to manage and prioritise a range of often competing commercial and operational pressures. In addition, many currently have little or no sustainability capability within the organisation and are unable to begin implementing for example a net zero strategy or transition plan without significant help from their private capital investors and external parties.

  It is therefore vital that private capital firms are empowered to frame emissions reduction initiatives, transition plans and other environmental impact frameworks in a positive manner that focusses

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management teams on the benefits to their business that these frameworks bring e.g. radically cutting back on GHG emissions can reduce costs, strengthen brand, increase exit value etc. This requires regulation applicable to private capital firms investing in SMEs to embed a respect for materiality and proportionality, which will allow tailored approaches for different sized businesses operating in different sectors/geographies, such that management teams for example recognise net zero plans and other environmental objectives as credible and engage with them fully, as a positive opportunity for their companies.

In terms of assisting SMEs themselves, we agree with the CBI that the Government should also incentivise positive behaviours by providing straightforward guidance on voluntary reporting standards for SMEs, alongside grants and guarantees to support SME access to private green finance. We would envisage streamlined and simplified voluntary sustainability reporting frameworks that are nonetheless compatible with the various frameworks imposed on larger businesses, such as TCFD, transition plans and SDR. In order to fully bring SMEs on board at the pace required, the Government will need to assume some of the costs, in the form of grants, and some of the risks, in the form of guarantees and funding programmes/products delivered by the British Business Bank.

Government policy must recognise the above considerations across the board so that rules, frameworks and guidance applicable to private capital firms do not force them, as investors, to burden SMEs with disproportionate or immaterial sustainability-related reporting requirements that risk fostering disillusionment amongst management teams and encouraging input-focussed box-ticking. Instead, policy must promote real, outcomes-focussed engagement on improving SMEs' green performance.

- <u>Different fund structures – the Government should ensure regulation is tailored for private markets and promotes a focus on outcomes over misleading disclosures</u>

  Private capital funds are typically closed-ended funds (i.e. investors commit capital for a defined period with no possibility of withdrawing their capital during that time). This allows private capital firms the necessary time (typically over three-to-seven year holding periods) to embed operational improvements in portfolio companies, without the risk of investors withdrawing their capital before such improvements have been achieved. These long hold periods are critical to private capital funds' ability to have a deep and long-lasting impact on portfolio companies' emissions and other sustainability performance. It is critical that regulatory frameworks designed for liquid funds investing in listed assets, whose investors can invest and divest freely and whose composition can be fine-tuned on an ongoing basis, say to maintain a fund's sustainability categorisation, are not simply copied over into a private markets context. Failure to adapt sustainability regulation for private markets will only lead to misleading disclosures and product categorisation that risks discouraging private capital fund managers from focussing on effectively greening their portfolios over the long term.

- <u>Different relationships with investors – the need to promote outcomes over box-ticking</u>

  The relationships between private capital firms and the relatively limited numbers of institutional investors in their closed-ended funds are inherently close and long-term. Communication between a firm and its investors is primarily direct, discussions on climate-related issues often occur in person, and public methods of communication are less relevant as investors base investment decisions on extensive, direct due diligence on the manager and the fund.

In this context, it is extremely important, both to the effectiveness of climate regulation and the attractiveness of the UK to private capital firms as a place to base themselves, that sustainability regulation does not lead to meaningful climate communications between firms and their institutional investors being supplanted by formulaic, inflexible and potentially misleading disclosures. Such disclosures may make more sense for more commoditised and intermediated products such as UCITS, but must be very carefully adapted for the private markets context to avoid discouraging investors from engaging in detailed conversations with private capital managers about actually achieving positive climate outcomes.

Whilst a degree of standardisation in what sustainability information is reported would be welcome, our members' experience with EU SFDR suggests there is a serious risk that simplistic disclosures and reductive product labels may be seen as substitutes for investors conducting detailed ESG due diligence and gaining a clear understanding of how a product's investment strategy and objectives relate to sustainability outcomes. This would undermine the Government's policy objectives and we strongly encourage the Government and regulators to consider how to avoid the UK green disclosure rules such as SDR leading to this outcome in the private capital context.

We welcome the FCA's recognition of this dynamic in some of its proposals to date (such as the FCA's 'on-demand' TCFD disclosure framework for professional investors), and recommend this continue.

Co-ordinated policymaking at the domestic level

Amongst other things, it is vital to the success of the UK's green policy initiatives that different Government departments and regulators work closely together to eliminate policy gaps and inconsistencies, and ensure that policies are implemented in a logical and coordinated manner.

Many of our members operate and are therefore regulated in the EU as well as the UK and are subject to EU sustainability regulation. Finalisation of much of the detail of the EU rules was repeatedly delayed. This, together with a lack of clarity in legislation, has led to considerable legal uncertainty, confusion among investors and significant additional costs. Firms subject to these regulations have had to make strategic decisions with incomplete information, and in some instances, have been forced to change their positions as more clarity has gradually emerged.

While we agree that there is a need for urgent action to deal with the climate crisis and to ensure that the UK remains at the forefront of sustainability regulation globally, it is important that the UK takes note of the EU experience and seeks to avoid further unnecessary uncertainty and disruption for regulated firms. The UK has acted quickly to mandate TCFD disclosures (which were already established internationally) across much of the economy, which we welcome, and we believe that it is important that the UK now takes the time required to develop robust and clear standards in relation to other sustainability disclosures.

In our view, it is critical that the UK rules, for example on SDR, are clear from the outset, and do not become fully effective until all the linked regulations and standards are finalised (including the UK's Green Taxonomy and the ISSB standards). To the extent that rules are effective before linked regulations (e.g. aspects of the UK's Green Taxonomy and any future social taxonomy) are fully developed and the market has had an opportunity to absorb them, transitional provisions should be included to reflect that.

We are also concerned that there has been little public development in BEIS' plans for the UK corporate reporting aspects of SDR that were set out in the Greening Finance Roadmap. In contrast, the FCA's work on SDR for asset managers seems to be progressing more quickly. We note that the quality of climate and other sustainability disclosures by private capital firms will rest on the quality of reporting that that they are able to gather from portfolio companies. This will be facilitated if regulatory requirements are timed to apply to larger corporates either before or simultaneously to the introduction of parallel reporting requirements for larger private capital fund managers.

International standards for a globally active sector

In common with other parts of the UK's financial sector, many of our members either have a US or, as mentioned above, an EU-regulated fund manager as part of their group, or are marketing funds to US, EU and other global investors. We therefore urge the UK to create a green finance framework that is consistent and compatible with other global regimes, especially EU SFDR, the US SEC's evolving rules on ESG disclosures, and corporate sustainability reporting standards in development by the ISSB (and EFRAG).

Where it is possible to align with the EU's SFDR, for example, in its approach to reporting against product-specific sustainability indicators and using a standardised list of principal adverse impact indicators (although the ISSB's output will also need to be considered here), we would support that. We believe that this kind of streamlining will make it less burdensome for our members and other parts of the UK's global financial services industry to comply with multiple regimes.

However, this should not constrain the UK from creating a system of rules and guidance that builds on some of the lessons learned elsewhere, in particular as regards clear and logical implementation and reflecting the specific characteristics of private capital funds investing in SMEs (as highlighted above).

Please do not hesitate to contact us should you wish to discuss any of our suggestions or evidence in greater detail (please contact Tom Taylor: ttaylor@bvca.co.uk)

Yours sincerely,

Michael Moore

Michael Moore
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