Club LONG-TERM INVESTORS

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HOW TO TAKE ON THE LONG-TERM CHALLENGE

Position Paper of the Presidency of the LTIC *

Enabling Infrastructure Investment: Addressing the Risks

The infrastructure sector faces major challenges. These include insufficient investments, partly due to fiscal consolidation, as well as shortcomings caused by poor project selection and planning, inefficient delivery and persistent emphasis on building new capacity rather than using existing assets optimally. Among the market inefficiencies, there is a lack of suitable project pipelines, inadequate risk-adjusted returns, prudential and regulatory constraints and high development and transaction costs. But there is also lack of public resources - due to tough fiscal constraints and high public debt which characterize many countries in the world - to complement cash flows coming directly from the projects, which often are not sufficient to make the economic and financial plans sustainable in the long term.

To increase long-term investors' asset allocations, infrastructure needs to be transformed from the realm of an 'alternative' investment category into a real asset class. This would then attract new streams of investment from around the world. Pension funds, insurance companies, asset managers, foundations, endowment funds and sovereign funds seem quite interested to invest

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** This paper has been written by Franco Bassanini (President of the LTIC) and Edoardo Reviglio (Chief Economist of CDP). Miscellaneous excerpts and ideas contained in this paper come partially from previous works by the authors. See in particular: F. Bassanini, *The Juncker Plan*, *Inaugural Conference - #Invest4Future,* Bruxelles, European Parliament, 13 April, 2015; F. Bassanini and E. Reviglio, *Infrastructure as Long-Term Investment Tool for Sustainable and Comprehensive Growth*, D 20 Opening Speech, Istanbul, 25 May 2015; F. Bassanini and E. Reviglio, *Long-Term Investments in Europe: from the Financial Crisis to the Juncker Plan*, in *Investing in Long Term Europe. Re-launching Fixed, Network and Social Infrastructure,* edited by Paolo Garonna and Edoardo Reviglio, forthcoming, LUISS University Press Rome 2015.

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The Long-Term Investors Club (LTIC): Fostering Economic Growth
In 2009 Caisse des Dépots, Cassa Depositi e Prestiti, the European Investment Bank and Kreditanstalt für Wiederaufbau created the Long-Term Investors Club (LTIC) with the aim of bringing together major worldwide institutions to emphasis common identity as long-term investors, to encourage cooperation and to foster the right conditions for long-term investments in promoting growth. Today the Long-Term Investors Club gathers 18 major financial institutions and institutional investors from all over the world mainly from G20 countries, representing a combined balance sheet total of USD 5.4 trillion. The LTIC has done much progress since its foundation to foster long-term investment not only in the EU but globally. Cooperation among members has developed sensibly and policy makers, at the European and G20 level, are increasingly aware of the role LTIs can play. For more information: http://www.ltic.org .

more in infrastructure. In the Brownfield infrastructure, yields are usually attractive for institutional investors. In the Greenfield infrastructure the higher risk requires of course higher IRR that often can be achieved only with a contribution of public resources (grants, guarantees, fiscal and other type of regulatory incentives) is normally provided. Today they invest on average less than 1% of their total assets in this sector. In Canada and Australia, by contrast, pension funds and insurance companies invest over 15% of their assets under management in infrastructure.

So governments and public administrations, international regulators and the financial industry need to do a lot of work. Development institutions from the G20 countries (the so-called D20) will play a growing role in facilitating the process at the national, regional and global level.

Schemes financed by public private partnerships and other private finance initiatives may be part of the solution. Today, globally, these account for only about 10% of total infrastructure financing – while 54% is financed by taxpayers' money and 36% by corporates. One way to attract global long term investors into infrastructure financing is to improve the quality, innovation and standardization of projects and financial products alike.

Governments need to accelerate what it is needed to be done. Those under fiscal pressure can build on various forms of taxes, user fees and divestures. They may capture property values of land and other real estate to raise funds for new investments or to reduce the price of the infrastructure by providing the land. Governments should intensify privatization of brownfield assets and utilities to finance new infrastructure developments. Governments need to increase private and institutional investors' participation in PPP-like structures by establishing comprehensive policies in this sphere, with an appropriate legal and institutional framework. They should increase transparency and provide visibility in project pipelines, establish efficient bidding and procurement processes, and improve risk distribution by providing credit enhancement and/or co-investment mechanisms.

The global financial industry can increase availability of long-term financing through standardized financial documents, agreements and contracts. Also necessary are methods to facilitate refinancing or resale of mature investments on the books of institutional investors and development banks.

Establishing infrastructure as a fully-fledged asset class will open up this category to a broader range of investors and pave the way towards innovative financial instruments, capable of bundling and securitizing equity and debt of investment vehicles with well-defined risk-adjusted returns and customer-focused investment periods.

The industry needs to develop local and regional capital markets and give a boost to capital market instruments (such as project bonds and asset-backed securities for project financing loans). This requires a new complementary relationship between banks, capital markets and institutional investors. The Juncker plan for greater investment in Europe has an important role to play here.

Despite this change in public outlay, there is a need for new models that engage private sector investors, that can help them to deal with the current low interest rates environment and provide a predictable (inflation adjusted) cash flow with a low correlation to existing investment returns.

The rationale is that financial markets, the real economy and society form a holistic entity. Each depends on the other two. None of the three is inherently stable. In the interplay of economy, society and financial markets, social infrastructure provides a key catalyst for employment, money and interest. This is why we believe that social infrastructure is a desirable option for long-term investors and an under-utilized resource for public service and social sector providers.

Governments, Industry and Regulators: the Infrastructure Challenge

Let us briefly go through some of the major challenges that each of the main players will need to face.

Governments. To increase private and institutional investors' participation to PPP and PFI for infrastructure, national Governments should: establish a comprehensive policy, legal and institutional framework for PPP; increase transparency and provide visibility in project pipelines; provide lean administrative procedures, cut red tape, regulatory and bureaucratic burdens; establish efficient bidding and procurement processes; work on the distribution of risk by providing credit enhancement and/or co-investment mechanisms and instruments; provide technical assistance to achieve streamline project delivery by shortening time and risks and defining pathways with clear criteria and time limits; establish leading practices to protect investors' rights and their enforceability; reduce forecasting risk; provide clauses to mitigate sovereign risk; mitigate political and regulatory risk. Finally, to increase efficiency it is crucial to optimize life-cycle cost, meet budgets and enforce competition between bidders to drive price down.

Financial industry and regulators. The global financial system needs in general to increase availability of long term financing for investment. The Long Term Investors Club (LTIC) has been lobbying for this since 2009 and finally it seems that the issue of importance of long term investment has been universally accepted. To make long term investment attractive the financial industry should promote standardized financial documents, agreements and contracts; render easier and more rapid the re-financing or selling off of mature investments on the book of institutional investors and development banks. Regulators should facilitate the financing of infrastructure by the banking sector removing regulatory disincentives to long term investments, especially in the construction phase (i.e. capital and liquidity ratios). There is general consensus that today the regulatory framework is unfriendly to infrastructure investments. Let us try to avoid at least that it does not get worse, as it appears to be the case with future up-coming Basel IV.

The cost of valuating projects for investors must be mitigated – in various ways – but mostly by setting up less risky and more standardized financial instruments; investors that look for assets to match their risk appetite and future liability need reliable cash flows and long term nature infrastructure projects; establishing infrastructure as an "asset class" in order to attract broader range of investors would pave the way to innovative financial instruments, capable of bundling and securitizing equity and debt of investment vehicles with well-defined risk-adjusted returns and customer-focused investment time frames, and, finally, it would translate to lower transaction cost, which are - especially for small and medium institutional investors - still too expensive, by standardizing and categorizing risks and their allocations, especially in order to bundle small and medium PPP projects and project financing loans.

Bank lending still covers around 65% of global project financing – so the supply of loans by banks will remain high in the future, that is also why we need to recalibrate regulatory frameworks to make them more long term investment friendly; banks, moreover, can provide a catalyzer role also in bringing non-bank long term private investors into the projects. Reducing leverage rate may also increase institutional investors' infrastructure allocations. Finally, to un-lock additional institutional investors' funds regulators need to lower current barriers such as: investments limits on infrastructure and capital adequacy and reserve requirements. Regulation should recognize that infrastructure debt has statistically default and recovery rates lower than corporate bonds, which determine much lower capital absorption. The aim should be to create a new asset class which

could be placed in institutional investors books between sovereign bonds and corporate bonds. There is, by now, wide consensus that with no recalibration there will be no new "asset class" for infrastructure financing.

Multilateral Development Banks, Regional and National Promotional Institutions. Global financial markets are undergoing a great transformation. In that process, they are not fulfilling, as they should, their necessary role in financing the real economy (primarily in terms of long term, patient, capital investment). Development or promotional banks are in a position to partially fill in that gap; by further using their risk absorption capacity and by acting as a broker of developmental/transformational financing. There is a great opportunity for development banks to re-invent themselves. They have the credibility to act as intermediaries of financial flows for a number of reasons: long history (track record); predictable (non-volatile) behavior; known for carefully structuring transactions; in-depth local knowledge; benefit from preferred creditor status not tainted by financial crisis abuses. Moreover, a large majority of them have political weight and have delivered returns consistent with risk (and market).

Moreover, development banks fill market failures and may have a role in balancing economic cycles. They may also have a subsidiary role to support commercial banking, which may receive cost-covering margin for on-lending promotional loans on nondiscriminatory basis. In doing this they become, in specific circumstances, complementary to the market, on the principle that privileges of development/promotional bank (tax exemption, public guarantee) do not distort competition. The costs of promoting are low (as the promotional bank does not need local branches and they often enjoy State-guarantees on the funding and/or the lending) and only economically sound projects (examined by the on-lending banks) are promoted. However, in some cases the Promotional Banks may be decide to finance projects with a level of risk/yield that commercial banks would not be alone ready to finance. Obviously they have to respect State Aid rules and be able to prove that they are filling market failures.

Among the new instruments which may need to be reinforced by Governments' agencies, Multilateral Development Banks (MDBs) and National Development Banks (NDBs), there are credit enhancement mechanism, such as monoline mitigation mechanisms, which may include credit and risk guarantees, first-loss provisions, and the provision of bridge financing via direct loans. Moreover, they may give special liquidity provision if needed.

The key point is that development banks are different from commercial, poly functional, universal and investment banks (viz other categories of banking) in that they have the aim of providing medium and long-term capital for productive investment, often accompanied by technical assistance. Also, the productive investments should be identified, appraised and selected with a two-fold set of criteria: in the short term, they should help make full utilization of production factors (and thus increase employment) and in the medium and long term, they will provide physical, financial and technical capital (and thus, increase productivity of the production factors). In short, they should be both Keynesian and neo-classical. This, we may consider as one the key discriminating feature between development banks and other categories of investment banks.

In any case, development needs development finance which is a special blend of finance - not just equity or lending (even concessionary lending). Development finance does not mean merely long-term finance, but long term finance coupled with the capacity to provide technical assistance to the borrower and to evaluate financial and social returns as well as to assess the opportunities and the risks inherent in development projects and programs and to formulate supporting policy measures. Only institutions with this capacity can, for example, evaluate a program of investments and associated changes in the tariff regime, fiscal transfers, and regulations or appraise a major

infrastructure program and address its environmental dimensions. Specialized knowledge must be integrated with finance.

New instruments and new agencies (MDBs and NDBs) are therefore going to be needed to mitigate risk and face credit crunch. They should work as catalyzer of institutional investors participation to infrastructure financing by playing credit enhancement and leave to institutional investors the senior part of debt and by attracting co-investments in the equity side of the projects.

In Europe, in particular, while waiting for a return of stability in the banking system, the role of large national and multilateral development banks (EIB, KfW, CDC, CDP, ICO) has become increasingly important. New financial instruments have been designed; additional resources have been mobilized to support the economy during the crisis, most importantly by financing infrastructure and SMEs, either directly or through the banking system; and new European and domestic long-term equity funds have been launched to invest in infrastructure projects and strengthen company capitalization. Cooperation between these institutions could lead to further new initiatives and new instruments.

In general, non-banking financing of infrastructure is probably the most important topic for the creation of a global "asset class" for infrastructure financing. So the issue – as we already tried to discuss - is the real game changer. It means developing local and regional capital markets and giving a boost to capital market financial instruments (such as Project Bonds and ABS on project financing loans). It means finding e new complementary relationship between banks and capital markets – and banks and institutional investors.

Financing and Supporting SMEs

SME is another long term sector which is crucial for the economy. SMEs are vital sources of productivity growth, innovation and, therefore, economic growth and job creation. At the global level they employ more than two thirds of the private sector workforce, and provide over 80 percent of net job growth (B 20 SMEs and Entrepreneurship Taskforce, 2015).

There is a growing attention not only in the EU but also at the global level to find common solutions and create a more level playing field among SMEs in different regions and countries of the world. The *B 20 SMEs & Entrepreneurship Taskforce* has launched the *World SME Forum* (WSF) announced on May 20, 2015, in Istanbul. The WSF is a global SME platform geared to supporting implementation of the proposed recommendations, and a major initiative to drive the SME sector's contributions to global economic growth and employment. The project is ambitious. The areas of engagement are: regular consultations at the global standards-setting bodies such as the Financial Stability Board (FSB) and in the relevant G20 working groups; building capacity, technical assistance, and advisory services for the application of international standards in the provision of certified information about SMEs regarding products, business efficiency, management, quality, and financial standing through on-line connectivity platforms; facilitating access to finance for SMEs by carrying out capacity building and providing technical assistance on how to become "investment ready" – including facilitation of a SME credit-rating toolkit and development of supporting infrastructure; fostering collaborations between the scientific community, the private sector, and the public sector unleash the innovation potential of the SME sector (B 20 SMEs and Entrepreneurship Taskforce, 2015).

With the creation of the World SME Forum the G20 is giving a strong message on the growing importance that SMEs across different regions and countries should gradually set common

standards and behaviors - as it is to a large extend in world of large corporations - to facilitate business relations and financing conditions.

So much is happening around the SME sector worldwide.

At the European level there are several initiatives which have been set up in last few years and some new ones which are emerging with the Juncker Plan and the Capital Market Union and which we will briefly discuss later on in this paper.

In the Small Business Act (SBA, 2008) it is stated that it is crucial to remove those problems that hamper SMEs' development, among which: administrative burdens, access to finance, access to new markets, unfair competition, shortage of education and skills for entrepreneurship, difficult in protecting intellectual property, shortage of resources to invest in research and development.

The SBA is the EU policy framework aimed at strengthening small and medium businesses, and it is aimed to put into place a comprehensive SME policy framework for the EU and its Member States, aimed to strengthen the role played by SMEs. In particular, one of the main objectives of SBA is the improvement of SMEs' access to finance. To this end, the European Commission has defined three major priority areas: access to loan guarantees for SMEs through strengthened loan guarantee schemes; action plan for improving SMEs' access to finance, including access to venture capital markets, as well as targeted measures aimed at making investors more aware of the opportunities offered by SMEs; allow all banks, independent of size, to easily implement EIB loans and EU instruments.

In particular, access to finance is a key issue for business start-up, development and growth for SMEs, as they have very different needs and face different challenges with regard to financing compared to large businesses. The latter have ready access to equity capital markets, which are not accessible to the vast majority of small businesses. The lack of equity capital invested in small firms makes these businesses more reliant on other sources such as bank lending and other types of financial products.

And in this framework, as the financial distress has to date lowered credit supply, it becomes even more relevant to SME to attract equity investment.

Although only a small proportion of businesses actually use or consider using equity finance, it is an important source of finance for SMEs. That is particularly true with respect to the early, pre-revenue stages of company development, when certain businesses could not be able to obtain debt finance because they may not have sufficient cash flow to service repayments. Moreover, it is relevant to notice that equity investment is a significant source of financing especially among those firms that have strong and rapid growth prospects because willing to invest these resources in growth and innovation, which are numerous among SME. In addition, SMEs can also greatly benefit from the involvement of investors in the running of the business through their expertise and personal contacts.

Yet, private investors are showing their interest in SMEs: private equity and "Informal investors" as Business Angels are in some cases bridging this equity gap.

What can be done to promote investment in SMEs? As already stated, a substantial demand for investment comes from small businesses, which to date have more and more difficulties in accessing credit to finance their growth and investments. However, the equity markets generally shows little interest in small businesses, even when they are healthy, innovative and with great growth potential. That is why, Public Sector and the EIB/EIF and Promotional Banks play a key role in supporting equity investments in SMEs, and especially in small businesses.

There are many various strategies and instruments to support equity investment in SMEs used in European and non-European countries. Most of these instruments rely on the involvement of private investors, so that small business can also benefit from the expertise, the know-how and contacts provided by the incoming investors.

Bank lending is still the main source of external funding for SMEs. During the crisis debt financing for SMEs had been strongly constrained and only most recently we see sign of recovery in the supply of credit. In the period 2008-2014, in general, higher interest rates and tougher collateral requirements have characterized this market. Total unmet demand for micro and SME credit is estimated worldwide to be 3.2 trillion to 3.9 trillion US dollars, according to International Finance Corporation (IFC). Further alternative sources of finance such as equity funding are still limited, volatile, and vary across countries worldwide.

Equity – and in particular long term equity – is important for two main reasons: (1) to counterbalance the massive deleveraging process started during the crisis - which most probably will continue for, at least, the next decade or so, and (2) to give financial stability to the system, which is the condition for a sustainable and long term economic growth.

This is the reason why Government's agencies and public/private banks throughout the EU have set up special funds providing minority long term equity (mezzanine and guarantees) to selected firms. They have done it to complement market failures which emerged after the crisis.

The public/private instruments newly introduced or reinforced with the crisis are based on "market conform" initiatives designed to support the long term growth of potentially healthy, strategic and competitive firms, both large and SMEs, in a phase of prolonged "credit crunch".

Although we see sign of lending recovery, as historical evidence shows, the deleveraging process is likely to be long and tough. In this context, given the increased difficulty in getting loans, especially to finance long-term projects, companies need additional sources of capital to support stability and to finance investments.

Moreover, there is in general in the economy a reduced investors' appetite for equity, leaving room for an "equity gap" between the amount of equities that investors will provide and what companies will need. This gap, without the necessary interventions, is intended to widen and weigh on firms' and countries' capabilities to invest and growth. This outcome, at a time when the global economy needs to deleverage in a controlled and safe way, appears to be particularly unwelcome. There is a need for solidity, for buffers of patient capital that can absorb potential losses during shocks without seeking speculative returns. There is a need for forward-looking capital investing through the cycles even for the ultimate benefit of future generations.

Stability is the name of the game, without stability there is no growth. Stability can be achieved by reducing the volatility and therefore the risk of too short cycles with very large peaks and bottoms. There is a need for flattening and extending the curves of the cycles through broad policy and long-term perspectives maybe associated with lower returns, but offering safety and ability to plan and look to the future with greater confidence.

The European Challenge

The challenges that Europe will have to face in the next decades are great. With high public debt and growing cost of Welfare State - mostly due to demographics - public resources for investment are going to be reduced or at best not much increased. So the EU will have to create a technically very skilled new model to finance infrastructure and R&D and support corporates and SMEs.

Infrastructure and SMEs are today the weak sectors of European economy. So supporting and providing long term financing to these two sectors should be one of the central goals of EU economic and financial policy. To this end a model capable to attract the huge stock of global long term saving which is seeking long term investment with the right risk/yield profile must be developed. If a new "asset class" for infrastructure will materialize at the global level, Europe will have to be ready to harvest a large enough quota of private saving to finance its fixed and social infrastructure needs. Such challenge can be met only if policy makers and industry work together to create a good pipeline of projects, a regulatory framework more friendly to long term finance and a set of long term financial instruments.

Increasing long term investment is extremely crucial to European economy. The concept has been first introduced at the outset of the financial crisis in 2008-2009 with the launch of the first Pan-European Long Term Greenfield Fund "Marguerite" and with the creation of the Long Term Investment Club (LTIC) by the EIB together with the major national Promotional Banks (German KfW, French CDC, Italian CDP). The Club's members rapidly increased and today it has a global reach gathering 18 large financial institutions from all Continents of the world with over 5 trillion in asset under management. The Club 's initiatives have contributed to build up a growing focus on long term policy activity at the EU level.

Also at the global level the concept was placed at the center of the G 20 Agenda, thanks also to the OECD which from the very beginning has invested much time and resources to study and disseminate the verb of long term investment. At the Saint Petersburg G 20 Meeting in 2013 – held under Russian Presidency – the recommendation to increase long term investment for a strong, sustainable and balanced global growth was included for the first time in the Conclusions of the Summit.

Towards a New Framework for EU Investment Policy

One of the major causes of the European long recession has been the fall in investment which exceeded €550 billion between 2007 and 2014. Such a fall included both private and public investment in all EU economies. As a consequence of the decline in investment the EU has maintained the ambitious goals of the Lisbon Agenda (EUR 2,000 billion in investments in transportation, energy and TLC), but (setting aside, at least for the moment, the idea of financing them by issuing Eurobonds) has planned to achieve these results mainly through private investment and, for infrastructure projects, through project financing initiatives.

Most recently, the new Commission has launched the so-called "European Investment Plan" or Juncker Plan. The Plan aims to unlock public and private investments in the real economy of at least € 315 billion over the next three years (2015-2017) without creating new debt.

The Juncker Plan represents a shift in the economic (investment) policy of the EU. Alongside with the two Communications on Flexibility and on State Aid Modernization, the general framework has been partially revised. New principles have been introduced. The first is the principle of fiscal flexibility – the "investment clause", for the first time, contains some timid "flavor" of the "Golden Rule" – in particular, contributions of MSs to the regional or thematic Platforms, under well-defined and tight macroeconomic and fiscal conditions, maybe exempted by the Growth and Stability Pact. The second is the principle of additivity ("filling market failures or sub-optimal investment situations"). The third is the principle of "good aid" – defined as "the decision on State aid on well-defined market failures and on objectives of general interest". The fourth is the "complementarity to the market" of National Promotional Banks – and the recognition of their

institutional role as pillars of the European Fund for Strategic Investment (EFSI) alongside with the EIB. Such principles are not shaking the foundations of the economic constitution of the Union – they are, however, seeds of potential future transformations. A change is needed both to promote a stronger EU Single Market and to reduce the competitiveness gap of the European economy at the global level.

The Juncker Plan must not be considered just as a new large Guarantee Facility for European SMEs and infrastructure. It should instead be considered as an anti-cyclical tool to boost investment and growth, and a first step towards the creation of a Single European Market for Infrastructure and SMEs financing. The Plan represents also an opportunity to stimulate national reforms and processes (legislative stability, streamlined and fast administrative procedures, light regulatory burdens, fast and reliable judicial systems, efficient and technically prepared public administration, information platforms, transparency, technical assistance, cutting red tape, etc). The architecture of the Plan is based on the "European Strategic Investment Committee" and by Platforms that can be regional and national as well as sectorial, to reach players and projects operating and existing at different grounds and in specific sectors. In the Platforms, an important role will be played by the National Promotional Banks, together with the EIB.

The idea behind the Plan – as already mentioned at the beginning - is that with an aging population, a public debt overhanging, and the tough competitive economic global challenges, the EU should rely on a system for financing infrastructure and SMEs which weighs as little as possible on public finance. The new model should be technically very advanced, as well as financially reliable and standardized in order to attract long term investors and private capital around the globe, where liquidity is great but is directed where risk is lower and yield is higher, and where the demand (and the competition) for capital investment will increase, at exceptionally high rates, throughout the XXI Century.

The EU Commission is realizing an Action Plan" on building a Capital Market Union. In the Communication there are listed important steps which involve infrastructure and SMEs financing. As far as long term investment are concerned the "Plan" includes the following actions [†]: Adjust Solvency II calibrations to provide a regulatory treatment for insurers that better reflects the true risk of infrastructure investments and provide recognition for investments in European Long Term Investment Funds; Complete the review of the CRR for banks, making changes on infrastructure calibrations if appropriate; Comprehensive assessment of EU retail investment product markets, including distribution channels and related services and examine how the policy framework could benefit from new possibilities offered by online based services and fintech. On SMEs: Support venture capital and equity financing; Proposal for pan-European venture capital fund-of-funds and multi-country venture capital funds, supported by the EU budget; Revise EuVECA and EuSEF legislation Study on tax incentives for venture capital and business angels to foster investment into SMEs and start-ups and promote best practice among Member States; Overcome information barriers to SME investment; Work with European banking federations and business organizations to structure the feedback given by banks declining SME credit applications and information on alternative financing options. Work with Enterprise Europe Network, to map out existing local or national support and advisory capacities across the EU to promote best practices on assisting SMEs which could benefit from alternative funding options; Support, with Member States and prudential supervisors, the development of industry-led business growth funds to support equity in SMEs; Work with Member States and ESMA, to develop a coordinated approach to loan origination by

[†] COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS. Action Plan on Building a Capital Markets Union (draft 24/10/2015).

funds and assess the case for a future EU framework; Investigate, building on work by the ECB, how to develop or support a pan-European information systems; Promote innovative forms of corporate financing; Publish a report on recent developments in crowd funding and, after this, decide on the best means to enable development of this funding channel; Strengthen access to public markets; Proposal to modernize the Prospectus Directive Review regulatory barriers to small firms admitted to trading on public markets; Ensure the regulatory environment for SME Growth Markets is fit for purpose; Explore, with the IASB, the possibility to develop voluntary tailor-made accounting solutions, which could be used for companies admitted to trading on SME Growth Markets Review EU corporate bond markets, focusing on how market liquidity can be improved; Support equity financing Legislative proposal on Common Consolidated Corporate Tax Base, including treatment of debt-equity bias. Finally, on building a securitization market: Legislate to revitalize simple, transparent and standardized (STS) securitizations and revise the capital calibrations for banks in CRR and subsequently insurers in Solvency II to incorporate the STS criteria (upon adoption of the STS Regulation); Consult on an EU-wide framework for covered bonds, building on national regimes that work well without disrupting them and explore the feasibility of covered bonds for SME loans.

Indeed a quite ambitious “Action Plan” which should be implemented with different timings in 2015-2017.

Financing Long Term Investment in the EU

In December 2008 the European Council gave mandate to the EU, the EIB and the largest national European Promotional Banks (KfW, CDC, CDP, ICO and PKO) to launch a long term Greenfield Fund for transport, energy and renewables known as the Marguerite Fund which started operations in 2010, becoming one of the largest infrastructure fund in the EU. In 2012 the EIB launched the Project Bond Initiative (PBI). The underlying idea of the PBI is to create a financial instrument that will facilitate debt capital market financing of infrastructure projects (“project bonds”) in the areas of trans-European transport networks (TEN-T), trans-European energy networks (TEN-E), ICT and broadband, thereby expanding the financing options for these projects. The financial instrument that has been jointly developed with the EIB, the Project Bond Credit Enhancement (PBCE) facility, is a subordinated instrument that supports senior project bonds issued by infrastructure project companies. The subordinated tranche functions as a protective layer to the senior tranche, thereby enhancing the credit rating of the bonds issued by the project companies. The Project Bond Initiative pilot phase was quite successful. More than 13 project have been financed and demand from major long term institutional investors (pension funds and insurance companies) has been very high.

Another issue which is crucial to long term financing is the transformation that the European financial system is undertaking. The European Union financial system is still mostly bank-oriented as only 1/3 is capital markets based. In the aftermath of the crisis, intervention in support of banks amounted to EUR 1,600 billion (including guarantees). It also required the banking industry to accelerate application of the most stringent prudential rules under Basel III and is introducing analogous rules for insurance and pension funds, with a consequent tightening in financing investment.

Committed to reducing the lever to correct the excesses of the past, European banks have lowered their capacity to provide medium and long term loans. At the same time, the crisis had negative effects on the borrowers’ and institutional investors’ confidence and appetite for risk. Credit

volumes have contracted in recent years. Signs of difficulty in the channels of financing to large companies, SMEs and families are clear and arouse increasing concerns. The corporate bond, securitization and risk capital markets in Europe are still relatively undeveloped compared with other economies and non-banking channels are still not accessible to the SMEs.

The important question is whether and to what extent it is possible to reduce the heavy dependence on bank intermediation of savings to the SMEs and infrastructure through a diversification of the European financial system with a higher proportion of direct financing of the capital markets, through the involvement of institutional investors and non-banking financial markets. The development of non-banking financial markets could also have positive effects on the recovery process in the banking channel because it could free up capital in the banks' balance sheets allowing the granting of new credit. It is necessary to act decisively on this front in order to avoid a possible crisis in the area of collection, with serious consequences on the entire European economic system.

Evidence indicates that the financing conditions for SMEs in Europe are still difficult. Many thinks that this is not a conjectural but a structural phenomenon and it will stay even after the crisis if the right policy actions are not properly taken and implemented. .The volumes of bank lending have been reduced in the last few years and in several MCs they are still falling. This is partly due to a decrease in demand, but it is also the result of a contraction in the supply of credit by banks due to deleveraging. In addition, interest rates for loans to SMEs are quite high and there are also significant differences between the various member countries.

Only recently Europe has taken steps on a number of fronts where it should have taken action earlier, such as harmonizing prudential supervision criteria and actions and speeding up the cleaning up of bank balance sheets (EBA rules, AQR, Banking Union and Capital Market Union). But the new banking and financial regulations, while useful for preventing new crises and ensuring financial stability, threaten at the same time to discourage investment in the real economy and infrastructure and, more generally, to generate pro-cyclical effects.

In order to foster long term investment in September 2014, the European Central Bank (ECB) announced a set of unconventional monetary policy measures (Quantitative Easing or QE) which include, among other things, the purchase of “simple and transparent” as well as of “high quality, mezzanine guaranteed” Asset Backed Securities (ABS).

Securitization is also a priority of the Capital Market Union (CMU); actually it is one of its vital components. ABS SMEs is probably the most needed one for the financing of the economy – since SMEs account for 2/3 of new employment and 58% of growth value added in the EU – but it is also the most difficult to implement. Easier is instead the securitization of mortgages. We should also not forget securitization of project financing loans for infrastructure – an essential step for the creation of infrastructure financing as a new “asset class” – a key component of the Juncker Plan. The Commission is carrying out a consultation on creating a framework for High Quality Securitization (HQS). It shall contribute to build up an “efficient and resilient” framework for Europe. Action in this direction may be taken by the Commission already in the second part of 2015. High quality structures and processes are crucial for a long term success of this venture. With low interest rates, capital retention to risk securitization becomes unattractive. However, we could rely on the EU to build our own European standards and sell it at the global level. Covered bonds are already EU regulated. The same could be done for ABS. Calibration remains one of the crucial points and time on this issue is of the essence. There is currently a broad consensus among experts (but now also among regulators and policy makers) that, under the current rules, there is

no “fair” correlation between capital requirements and the actual underlying risk of the securitized loans. The regulatory re-calibrations recently proposed by EBA go in the right direction but they are not enough. The EU adoption in 2014 of two delegated regulations on prudential requirements for insurers (Solvency II) and on liquidity for banks (the Liquidity Cover Ratio) introduced criteria also for securitizations. Now they need to be complemented and re-calibrated if we want a EU market for securitization to take off.

Policymakers have been trying to revitalize the market for securitization for almost two years now. The High Quality Securitizations (HQS) definition for Solvency II seemed to be a first step ahead. However, very little new issuance has been seen; volumes remain low, especially for SMEs, where we need them most to revive bank lending to the economy. Revised Solvency II capital charges for HQS only apply to the most senior tranches, they may create distortions with junior tranches and a risk of arbitrage due to the cliff effect.

At the moment there are two problems with ABS SMEs in the EU. The first is the heterogeneity of the underlying products. The second the availability of credit information. The banks have all the information needed but they are not standardized across EU jurisdictions. We need to build a system accessible to all stakeholders. The problem is that information is granular and based on national specificities. So we need to work on European platforms of standardized information. Transparency is a major prerequisite. The ECB and BoE requirements for loan by loan data as part of their collateral eligibility criteria and the market-led securitization labels go in the right direction. We still lack homogeneity in risk assessment, definitions of defaulted assets. This makes difficult to compare transactions. CMU is an occasion to tackle these crucial issues. Benchmarking different Member Countries is difficult. However, today we have the technology for this.

Securitization – in the context of the CMU – should be seen as a bridge between bank based and market base financing. SMEs securitization will become attractive only when recovery comes and the economy will need new funding. At that moment other sources will materialize. Now the level of capital expenditures is still very low. So the urgency is now to put the framework right. If the funding is so cheap, as it is now the case, why securitize? Big banks have no incentives. Since we still lack the basics for a pan-European solution, we should take this time to build the right framework.

Finally, for insurance companies there is still a number of serious issues to be solved before ABS can be attractive. An asset class is still not present a EU market does not exist, if there is no trading there is no liquidity; the market-to-market (Solvency II/Omnibus) is still quite unfriendly to ABS; insurance companies need large teams to evaluate such financial products, especially if there is a lack of standardization; there are still very different loan-to-value interpretations and several definitions of default across European jurisdictions; the cost embedded in the metrics process makes it difficult to construct reliable stress case scenarios; there is, in fact, a very high volatility risk which hinders on the validity of the processes of calibration.

Long Term Financing in Europe: the Need to Recalibrate Prudential and Accounting Standards

Another issue which is key for long term investment in Europe – as we already mentioned - is prudential and accounting standards. There is unanimous consensus on the negative effects on long-term investment of the capital and liquidity requirements under Basel III. A recalibration of prudentıal and accounting framework more frıendly to long term ınvestment is needed. However, so far, no concrete results have been foreseen. On the contrary, the Basel Committee is debating a new set of rules (Basel IV) which would make even harder (in terms of capital absorption and

liquidity ratios) to finance investment and the real economy. Moreover, a recent Report by the Financial Stability Board (March, 2015) is suggesting to revise the zero weighted treatment of sovereign and government-related exposures under the capital and liquidity requirements of banks (the Basel III agreement and CRR/CRD IV), including the large exposures regime, as well as the zero weighted treatment of sovereign and government-related exposures under the solvency rules of insurance undertakings (Solvency II).

Jacqyes de Larosiére at the Eurofi Forum in Luxemburg in mid-September 2015 made a bold proposal: to take tough action on CRDIV and Solvency by reducing (at least temporarily) the capital absorption for infrastructure and ABS SMEs. Calling for a sort of "recalibration shock" the French economist and central banker is asking policy makers and regulators to concentrate on two of the sectors which suffer the most in Europe: infrastructure and SMEs. It must be clear that the Juncker Plan and the Capital Market Union may not take off as they should if significant changes in the prudential and accounting standards are not implemented soon.

The risk – at the end – is that potential investors in the market for infrastructure and SMEs' financing will have no convenience to participate, even if they wish to do so, due to the effects of rules drafted with no clear understanding of the needs of economic growth (that is, long term investment). These rules are a binding condition for both financial stability and long-term sustainable fiscal consolidation. We should not forget that one of the fields on which global competition is playing its game is the setting of prudential regulations and accounting standards. The tough prudential and accounting regulation which penalizes the financing of real economy and infrastructures has become a major weapon in the global economic and financial war, which characterizes the XXI Century, hitting mostly more bank oriented systems.

The EU financial system, which is more bank-oriented than most of other major financial system in the world, pays in fact a greater price due to prudential regulations and accounting standards unfriendly to LTIs and to the financing of the real economy. This is not the case for market-based financial system such as the US and Government based financial systems such as China.

Moreover, the UE Member States have stricter space of manoeuver in the substitution of banking financing with State Aid. Finally, the European political and regulatory Authorities are always much more rigorous in the transposition and implementation of international regulations and generally provide less exemptions and less flexibility than those of other major countries (see for instance the transposition of Basel II and Basel III made in the US).

The tough prudential and accounting regulation which penalizes the financing of the real economy and infrastructures needs a "leveling playing field" to avoid "regulatory arbitrage" and support homogenous treatment of long term investment. Financial systems, which are more bank-oriented, may pay a greater price due to prudential regulations and accounting standards than market-based financial systems. We believe that international, regional and national regulators should work together to avoid regulatory and asymmetric global environments.

Conclusions

Re-launching investment is the key driver for striking a better balance between sustainable growth and fiscal/balance-sheet consolidation.

Long-Term sustainable Investment in the real economy in fact is essential for bridging both visible and emerging gaps that many countries have in infrastructure. Long term investment is also

required for enhancing competitiveness and innovation, particularly in the SME sector. Finally long term investment is the only way to face up to those long-term challenges confronting our societies: ageing populations, stressed health and social care provision, climate change, environmental degradation, social cohesion and quality of life that has remained static for most people in our communities for too many years.

Risk in long-term investing comes from many sources and safe investment involves a range of players. Managing such risk requires new parameters that will shape the behavior of - and options available to - institutional investors, regulators, intermediaries and capital beneficiaries.