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Improving the financing of projects to favour growth in the context of deleveraging and fiscal discipline

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Before the crisis, the European banking system financed around 2/3 of the debt side of the project financing initiatives (PFI) worldwide. The long-term institutional investors (LTIs) backed around 40% of the long-term (LT) bank financing for infrastucture (through corporate and structud bonds).

The financing crisis and the resulting new regulatory framework have undermined this well-functioning model. In fact, the European banking system is at critical crossroads. Deleveraging and new regulatory pressures are strongly limiting its capacity for long-term lending.[1] This has special negative effects on project financing and on European investments and economic growth.

In the last quarter of 2011, according to recent BIS data, loans for project financing dropped by 39% for weaker EU banks [2] and by 18,3% for other EU lenders. Market sources are in line with BIS data. The project finance bank market is still open for new financings, but tenors and amounts have been significantly scaled-back. The cost has risen up. Given current liquidity conditions in the loan syndication market, few banks are willing to take material underwriting risks. In addition, there are also growing attempts, by many European banks, to sell their project financing portfolios on the secondary markets. If we consider that before the crisis over 90% of loans to PFI was financed by European banks, then we must admit that we have a serious problem.

Let me briefly recap why this is happening. Then I will try to add few policy suggestions and, finally, I will raise some questions on what can be expected for the near future.

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[1] See, *European bank funding and deleveraging*, in *BIS Quarterly Review*, March 2012; and Gert Wehinger, *Bank deleveraging, the move from bank to market-based financing, and SME financing*, in *Oecd Journal: Financial Market Trends*, Volume 2012, Issue 1.
[2] The 31 banking groups with EBA capital shortfalls, plus all Greek banking groups.

Four are the major issues which should be taken into account in the current situation: (1) the shortfall of capital and the effects of Basel III on capital and liquidity ratios on LTIs; (2) the liquidity shortage in the European financial system (3) the need to clean-up European banks balance sheets and, last but not least (4) the regulatory differences among national systems, which are often already priced by the market, but are not taken into proper consideration by regulators and EU legislators.

Last year, the European Banking Authority (EBA) estimated that more than half of European banks fell short of Basel III capitalization targets by 242 billion euros. The EBA estimates were criticized on the basis that they did not take into consideration, as they should have done, the different regulatory national regimes. There is consensus now - among major banking analysts - that the capital shortfall is around 350-400 billion. Among the least "virtuous" banks are some of the largest French, German and Scandinavian ones. This makes the general framework even more worrisome, since together they compromise over 50% of the entire European banking industry.

As we all know, banks can improve (regulatory) capital ratios by mean of:

(1) capital increases on the market – but at current share prices the amount that can be raised and the resulting potential dilution effect make market capital increase quite burdensome – however, it should be the most recommended solution because the cost of deleveraging would be more fairly divided between shareholders and the economy, which needs LT financing;

(2) cutting dividends and increasing retained earning – this has a double counter-effect (a) brings down dividend-yield thus making less attractive the investment in bank stocks and (b) pushes banks towards shorter-term (more speculative) and more remunerative investments thus resulting in potentially more volatile (and riskier) investment ;

(3) finally restructuring their assets portfolios by selling their more expensive assets in terms of capital charges - i.e. risk weighted assets (RWA) - which is already part of the current deleveraging process.

Furthermore, funding conditions for European banks deteriorated in late 2011. As a matter of fact, the ECB decided to supply banks in the euro-area with two special longer-term refinancing operations (LTROs) at particularly favorable conditions. It has been estimated by the BIS that, of the cumulated roughly 1 trillion euros LTROs, one third was used (especially by Italian and Spanish banks) to do "carry-trade" (buying sovereign bonds), one third was re-deposit with the ECB in order to cover much of the potential funding needs from maturing bonds over the next few years, and finally only one third left was used to lend to real economy. The two ECB LTRO operations have temporarily eased the short-term liquidity crisis. But they could not

do much for medium- and long-term financing of the economy, and in certain cases had depressive effects on some banks' share prices (reputational effects).

In addition, Basel III does not help[3] with its new liquidity ratios[4] (now under revision), which are very important for project financing..

Industry analysts[5] estimate the total shortfall at about €1.3 trillion in short-term liquidity and at about €2.3 trillion in long-term liquidity for European banks.

Moreover, many (large) European banks still need to undergo a serious cleaning up of their balance sheets. A European TARP-like process should have been done at the beginning of the crisis. It was a lost occasion. BIS recently estimated that about one third of deleveraging might involve the selling or writing-off of low-rated securitized assets and other risky loans.

Finally, the Banking Union will require homogenization of different national regulatory frameworks. This will imply tougher conditions in some national banking systems. It will be a difficult and, at times, a painful but healthy process.

In short: The state of European banking industry is under severe stress and this will penalize especially long-term financing to the economy and thus economic growth. It will take time before European banks recover and some changes in their business model are expected.

In the meanwhile, will other financial institutions be able to substitute European banks in long-term lending as the latter continue to deleverage? May banks, asset managers and bond market investors from other countries (maybe coming from less restrictive regulatory frameworks) partly take over the business of European banks? May others European institutional investors get directly into the business of financing infrastructure?

Actually, the European Directive Solvency II for the insurance industry[6] dampens the holdings of long-term assets by traditionally longer term institutional investors (in search of appropriate financial instruments/assets in order to match the duration-gap

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[3] It should be noted that the short-term and long-term liquidity ratios are related. The short-term funding ratio is driven by two factors: the liquidity buffer on the asset side of the balance sheet and the outflow on the liability side. More long-term funding on the liability side means less outflow, hence a higher liquidity ratio and a smaller liquidity gap.

[4] The Liquidity Coverage Ratio (LCR) is defined as the stock of high-quality liquid assets divided by total net cash out-flows over the next 30 calendar days (≥100%); the Net Stable Funding Ratio (NSFR) is defined as the available amount of stable funding divided by required amount of stable funding (>100%). Although the NSFR consultation is still in progress, and the ratio is widely expected to be less punitive once it is finalized.

[5] McKinsey (2010), *Basel III and European banking: Its impact, how banks might respond, and the challenges of implementation*, McKinsey Working Papers on Risk, Number 26, November.

[6] There is an European Commission call to extend the scope of Solvency II to the pension fund industry.

implied in their business models) such as life insurance, and pension funds which have been historically the main providers of LT financing for banks.

Of course, it is most unlikely that the European financial systems will change radicali in the medium-term, from a bank-based into a capital market-based US style system. Too great are the cultural, regulatory and structural differences between the financial systems on the two sides of the Atlantic. The European financial system will probably become a more mixer but, for the time being, a still a mostly bank-based system.

But, while we wait for the European banking system to recover, some changes must take place.

To support PF and PPP initiatives, the ECB may take into consideration a 6-9 years LTRO. The two previous three years LTRO faced successfully the short-term liquidity crisis. A very long-term refinancing operation (VLTRO) of a much smaller size (100/200 billion) could be successful to overcome the present medium/long term crisis. Binding condition to be eligible to this especially dedicated facility should be the presentation of LT good quality collaterals (including the best guaranteed PFIs) and of a full documentation proving that it will be used only for LTI. This new type of ECB facility may be granted to large development banks (EIB, KfW, CDC, CDP, etc.) and/or to all European banks. Moreover, the projects to be financed should be fully bankable, following a satisfactory due diligence process.

At policy level, a number of actions have been already taken. But much more should be done in the near future, for instante in the following directions: (1) re-calibration of prudential regulatory framework (2) new EU LT financial instruments (3) mitigation of non-regulatory risk, and (4) introduction of fiscal incentives and other regulatory incentives.

First, to give a strong boost to investments in infrastructure it is crucial to rephrase the regulatory framework (Basel III-CRD IV, Solvency II, IORP, IFSR) that - as today - penalize LTIs. It is not a question of easing the financial stability framework, but to find appropriate fine-tuning solutions which assure financial stability and at the same time help the financing of economic growth, without which financial stability, as a whole, could tomorrow itself be at risk.

The definition of a new regulatory framework friendlier to LTIs is suggested by the Jacques de Larosière and Mario Monti Reports, by many Eurofi forums papers and by the European Commission in the Communications on A New Single Market Act[7],

[7] EUROPEAN COMMISSION COMMUNICATION, *Towards a new Single market Act,* 27th October 2010 – COM(2010)608.

on A Comprehensive European international investment policy[8], and on The EU Budget Review[9].

But, nothwistanding this broad consensus (among the majority of experts, scholars, bankers and politicians) on the need of a new regulatory framework and new instruments more favorable for LTI, the international and European regulators seem to be still prisoners of a pro-cyclical and short-termist cultural approach.

Second: new EU financial instruments are needed both on the equity and on the debt side.

On the equity side, the Marguerite and the InfraMed Long Term Infrastructure Funds have been well received by the market. They should be taken as prototypes for a series of LT Funds (providing both equity and mezzanine, as is the case for the Energy Efficiency Fund) for infrastructure and/or other sectors, such as innovation and mid-cap high growth SMEs, venture capital, public utilities, urban development, health, etc. After the crisis, in fact, there is, at least in Europe, a huge equity crunch and a great need for LT equity to stimulate LTIs in the economy

On the debt side, the large national development banks (EIB, KfW, CDC and CDP), may consider to join forces creating a single or several common funds for debt (backed by guarantee schemes) for infrastructure and, and more generally, for LTIs.

Within such context, the EU Project Bond Initiative, together with the EIB, becomes crucial for the financing of the European recovery and infrastructure investment. Moreover, a new market of EU Project Bonds and the scaling back of bank lending to this sector translates into an important opportunity for institutional investors involvement, particularly given the long duration nature of project/infrastructure asset.

Third, the development of PFI and PPP requires good projects as well as some environmental conditions, such as a good and stable regulatory framework, with reasonably low regulatory and bureaucratic costs, a reliable judicial system and an efficient as well as technologically skilled public administration and government services. To assure this conditions a strong political action is needed, especially in some European countries.

Fourth, the EU Member States should support PF and PPP with tax incentives. Tax incentives, to increase the attractiveness of the PFIs, may serve both growth and fiscal consolidation objectives, up to the point at which the incentive does not overpass the new fiscal revenues directly produced by the new investment, net of

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[8] EUROPEAN COMMISSION COMMUNICATION, *Towards a comprehensive European international investment policy*, 7th July 2010, COM(2010)343.

[9] EUROPEAN COMMISSION COMMUNICATION, *The EU Budget Review*, 19th Oct. 2010, COM(2010) 700.

substitution effects. Tax incentives should be provided also to promote long-term saving and long-term shareholding.

To promote investment in the New Generation Networks (NGN) in order to reach the European broadband target, in particular, the European and the national regulators could design systems of tariffs based on Regulatory Asset Base (RAB) – at the condition that the infrastructure is open to all operators in the market.

At the market level a stronger role may be taken over by institutional investors. However, we cannot expect that alone they can substitute banks. For project financing, for example, they can leverage on bank flexibility in financing the construction phase of infrastructure projects by providing – after that - the long term refinancing of the project investments. In this way they could become a powerful long-term financial engine for a strong, balanced and sustainable growth.

At the global level the largest institutional investors (insurance, pension and mutual funds) hold asset worth about 49 trillion euros – of which 16 trillion at the European level. Despite a recent increase in allocation to infrastructure, it has been estimated that less than 2% of total assets worldwide is invested in infrastructure as an asset class.[10]

To conclude. We need to make changes in the EU prudential regulation to increase the potential of European banks in lending long-term and to increase the appetite of institutional investors for infrastructure as an asset class. We need to take action for two reasons: first, to give more power and competitiveness to European financial industry in fostering LTIs and, second, to make European project financing attractive also to non-European investors.

The demand for LTIs globally is going to be huge in the future. The regions of the world which will be able to attract capital will have a competitive advantage. It is time that EU policy makers understand this challenge. The time to act boldly is now.

[10] Estimates provided by Morgan Stanley (2011).