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What role and evolution for the financial system and its regulation to ensure a sustainable financing of the EU economy?

What should be done to launch an European capital market for infrastructure

by Franco Bassanini

1.- In Europe, the market for the financing of infrastructure remains mostly in the hands of commercial banks. With the advent of Basel III the situation might get worse for long term investments in infrastructures (LTII). The need to increase capital requirements, in fact, will most probably favor the holding by banks of assets of risky nature and the reliance of short term markets (and decrease their participation to long term initiatives, with negative effects on economic growth). On the side of institutional investors, which should be the most natural recipients of long term investments, the absence of the monoline industry and the new regulation represent fairly high barriers for appetite in project financing as an asset class. There is, by now, a general consensus (shared by the Commission) for the need of a new regulatory framework more favourable to LTII, along with the need to launch new financial instruments to finance European infrastructural networks (such as European equity funds, Eurobonds and project bonds), and to provide fiscal incentives for LTII.

In general, the new regulations for banks and institutional investors seem to go in the right direction as long as they reduce the chances of a recurrence of the events which provoked the financial crisis. However, in the case of

financing of long term investments, as they stands, they will have, at least in short and medium time (next 3 to 5 years, which are crucial to exit the crisis), some real negative effects.

The need to raise more capital will most probably result in less availability of longer term credit. More generally banks will tend to seek higher profitability (to retain higher capital levels under Basel III) which means their lending margins will be higher. Moreover, under Basel III rules, banks have to allocate less capital for shorter term credit transactions. In short, the additional capital requirements may lead banks to either reduce their long term loans or select more remunerative, but also more risky, assets. This will have negative impact of the willingness of banks to lend long term.

Insurance companies, pension funds, and other long term institutional investors should be the "natural" home for financing infrastructure should have a regulatory framework properly fine-tuned considering their role and specific business model. However, after the financial crisis and under current accounting and regulatory changes, life insurance companies and pension funds find more difficult to play their traditional role of long term investors. Under Solvency II standard formula the capital charges on long-dated corporate are very onerous. This means that the yields available, after the cost of holding Solvency II capital requirements, are not attractive to insurers at current prices. In fact, under the present conditions. Solvency II may have negative effects on the potential demand for project bonds (and EU long term equity for infrastructure)putting a question mark on the success of the Commission initiatives for supporting financing infrastructure in the Union. Also, from a more systemic point of view, the role of LTIs as providers of long term capital in a well-balanced and strong global financial system has not been addressed properly as yet. This might have high negative effects on the efficacy of the financial system in sustaining and fostering economic growth.

2. - As I already said, the combined effect of the regulatory reforms to deliver stability and of the financial crisis on banks restructuring, has been to reduce the appetite of many commercial banks for long-term project financing initiatives. This makes the creation of an European market for project bonds undoubtedly an initiative which might go in the right direction.

The aim is to attract private capital to finance infrastructure projects in the fields of transport, energy and TLC. A new asset class should emerge which should guarantee sufficiently high credit rating and provide investors with the diversification opportunities they need.

Long-term investors such as insurance companies and pension funds may find a long-term asset such as the project bond a good match with their long-term liabilities. Global Investors total assets are estimated by the OECD in over 54 trillion. If only one percent of these assets were invested in European infrastructure this would cover roughly between 25-30% of total estimated European infrastructure investment needs.But in order to do so they require primarily that the market be liquid, otherwise they would not consider such investment as attractive.

However, as I have already mentioned, Solvency II makes the holding of long-term bonds quite "expensive" in terms of capital requirements. Capital charges are, in fact, higher for financial products with the same rating but longer durations. Financial assets backed by regulated infrastructure enjoy long-term stable cash flows streams and offer lower risk *premia*; their risk/reward profile should be taken into consideration. Since the default curve and the expected recovery rates are typically often better for infrastructure bonds than for corporate bonds, it can be critical to stimulate a regulatory effort to introduce a different capital requirement. This would help to create an attractive asset class which could be placed between government bonds (zero weighted) and corporate bonds.

I believe that an effort should be made by the Commission for a more integrated approach so that the resources the EU budget be more effective in rendering more attractive the credit enhancement mechanism built-in EU Project Bonds.

3. - On the side of equity for infrastructure there is also the need to provide longer duration and lower IRR to finance more leveraged project financing initiatives, especially in more risky sectors such as large European transportation networks (TEN-T). In this direction in the aftermath of the crisis two new Equity Funds were created the Marguerite and the InfraMed, also with the aim to support the Private Equity Infrastructure Funds which are seeking for higher returns and manage shorter duration, especially for

Greenfield projects. InfraMed and Marguerite funds have now begun their investment activity in the EU27 and the South East Mediterranean countries. We wish that within the next EU 2014-2020 Financial Framework further "innovative financial instruments" will be developed in order to mobilize private funding besides traditional EU budget spending.

Project bonds and long term equity funds may be together part of the solution for financing infrastructure by increasing the size of the European capital markets to compensate for the retrenchment of the banking system which is in this phase of the crisis under stress. To be successful, however, we need still some changes in the regulatory framework, as well as fiscal incentives, which I will briefly discuss next.

4. - Regulatory changes are not the only actions needed to create a larger European capital market to finance infrastructure. The tax regime may also be a crucial driver.

In general, there is in Europe the necessity of a more coordinated fiscal policy. As suggested also by the Monti Report, in some areas, progress on the tax policy side may offer the EU the possibility to use taxation as a tool to complement regulation to achieve agreed policy objectives.

The strategy indicated by the Monti Report has been received by a Communication of the European Commission with the goal of producing by 2011 a Directive to introduce the *Common Consolidated Corporate Tax Base* (CCCTB).

In the last Eurofi Meeting in Wroclaw the issue was approached mostly on the disadvantages of equity finance as compared to debt finance.

The recommendation was then "Ensure the fiscal stability required for medium and long-term investment, and do not fiscally discourage share issues." (*Ibidem*)

According to the Eurofi proposal Governments could introduce an *Allowance for Corporate and Project Equity* (ACPE). The ACPE applies a nominal interest rate to a project or company's total equity capital and

reduces the tax base. As a consequence, the effective tax rate can be greatly diminished, depending on the capital structure (Debt / Equity ratio). ACPE plans currently exist in Italy and Belgium , and have existed in Austria, Croatia and Brazil.

Fiscal incentives may also be given to those who hold an infrastructural asset for a longer period of time (say 5 years). In that case the investor may not have to pay for the eventual capital gain acquired. This type of solution is already applied, for instance, in the real estate sector in Italy.

Furthermore, considering the need to reduce public debt, tax incentives could be granted in substitution of direct budget contribution ibn order to make financially attractive the project finance or PPP initiatives. However, such solutions may be considered in the light of EU State aid discipline.

But the relevant positive externalities produced by the investments in infrastructure (as well as I R&D, high-tech and environment) may suggest a more dynamic, pro-growth and pro-competitive approach to State regulation provided that the fair competition among investors is assured.

Finally, we may apply fiscal incentives directly on the project bonds. This would have two type of advantages. The first to bring the tax treatment of project bonds at the same level of debt for infrastructure. The second to have the incentive on a specific EU financial instrument – backed by the EU and the EIB – and not generally on a vague and more difficult to define notion of "bonds for infrastructure" (what is exactly and what is not an infrastructure?). In this field, Europe has much to learn from the US, where the reation of a market of fiscally attractive project bonds (the BABs) worth 200 billion dollars have been a success story of the Obama Recovery Plan, giving a strong boost to the sector.

5. - To conclude. There is, by now, a general consensus (shared by the Commission) for the need of a new regulatory framework more favorable to LTII, along with the need to launch new financial instruments to finance European infrastructural networks (such as European equity funds, Eurobonds and project bonds), and to provide fiscal incentives for LTII.

Not enough, however, has been done so far: the first European funds (Marguerite, Inframed, EEEF), now operating, and the Project Bond (PB)

Initiative, supported by the EU and the EIB. They could play a crucial role in attracting capital markets into greenfield infrastructure projects and would enable the long term provision, to move from banks to investors such as life insurance and pension funds: a new asset class backed by infrastructure could then be placed in the portfolio of global long term investors between government bonds and corporate bonds.

But, to attract private capital in the financing of infrastructures, we need more coordination at the EU level to create a better fit between regulation (CRD IV, Solvency II), the "European Connecting Facility" and the PB Initiative; and we need fiscal incentives for financing infrastructure.