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Long-term investment in Europe The origin of the subject and future prospects¹

The topic of long-term investment, proposed by the *Cercle des Economistes* and the *Italian Embassy* in Paris, has now become absolutely crucial. Economic recovery, still facing the threat of triple-dip recession in the southern European countries, and renewed competitiveness in Europe require strong investment in the real economy, infrastructure, innovation and research and development. This is also required to continue on the path towards the consolidation of public finances, which cannot be sustained over time without the recovery of a reasonable level of growth (and inflation). In Italy, for example, annual expenditure for public investment slumped over 50% over the last five years, and the spending review process, although carried out with great determination and precision, will not succeed in recovering previous levels. Clearly, the financial breathing room that this process will create must be applied to reduce the public debt (imposed by the fiscal compact) and to bring much-needed tax relief to employers and businesses.

As Ambassador Magliano reminded us, it was thanks to cooperation between Italy and France that the subject of long-term funding of the economy has been introduced and developed within the European Union since autumn 2008 and from there was extended to include, through the G20, the rest of the world. We brought this issue up in a paper signed by us and presented at the 2009 Eurofi Financial Forum in Gothenburg, which indicated, among other things, the legislative corrections required for the elimination of those regulatory handicaps that penalise long-term investment in the real economy and in infrastructure, and which promote short-term financial commitments. This paper was met with general indifference, but for one very significant exception: Jacques de Larosière. He relaunched the issue and encouraged us to continue, since, in this case, the pros and cons cannot be counted but must be weighed. Larosière's approval enabled us to understand that it was only a question of time. Indeed, just two

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years later, the Eurofi Forum fully embraced the issues vainly set out in Gothenburg.

Nevertheless, in the meantime other events permitted a series of initiatives to be put together to renew long-term investment. In Paris, in autumn 2008, the leaders of the four major European public development banks (EIB, KfW, CDC and CDP) met at the Hotel de Pomereu, the historical seat of the *Caisse des Dépôts et Consignation*, to respond to the request of the European Council to study the feasibility of creating a large European fund for infrastructure and energy. This was based on a proposal made by the Italian Minister of Economy and Finance to the informal Ecofin of 28 September 2008. The proposal had three objectives: (1) to give a strong political message on the need to strengthen the funding of the European economy at a time of deep crisis and confusion; (2) to support the recovery of the infrastructure financing market (and Small and Medium Enterprises SMEs), and (3) to create a large network of European banks in favour of the long-term growth of the European economy.

We've come a long way since then. Not only in Europe, but throughout the world. The concept of long-term financing of the economy is now on the agenda of governments, large international organisations, national and international regulators, the G20, the market and the European Union (EU). In Europe, in particular, the Commission has produced an "Action Plan" which contains the road map for the next European legislature. It contains a series of clear directions. For some there is a broad consensus, others less so. Some technically easier to carry out, others harder. In general, however, the market, the banks and businesses are on the starting line and pushing for many of the proposed initiatives to be started. The governments and the EU are aware of this and recognise its urgency. The Italian Presidency of the European Semester will have the task of guiding the process from one European legislature of the European Parliament to another. After four years of many words (and little action), it is high time to move on to the implementation of concrete public policies.

A brief chronology: 2008-2013

However, before going into the merits of today's theme, we will very briefly recall a chronology of the main proposals and initiatives which have taken place at European (and global) level, in the area of long-term investment after that meeting at the Hotel de Pomereu referred to at the outset.

In December 2008, the European Council gave the green light to the establishment of the Marguerite Fund, which becomes one of the main Greenfield funds in Europe.

In the early months of 2009, *Caisse des Dépôts*, *Cassa Depositi e Prestiti*, the EIB and KfW create the Long-Term Investors' Club (LTIC).

In June 2009, the first Annual Conference of the Club was held with the participation of some well-known economists including Olivier Blanchard (Chief Economist of the IMF), Pier Carlo Padoan (Chief Economist of the OECD) and Nouriel Roubini, as well as representatives of the national and European institutions, of the financial industry, of investors and the major international press. The OECD participated as a co-sponsor of the conference and from that moment became a stable partner for many of the initiatives of the Club. The subjects addressed in the first Annual Conference of the Club were: the need for long-term investment for growth and stability, the financing of the infrastructure and the SMEs, the relationship between long-term investment and accounting standards, and the relationship between the short- and long-term vision of financial investments.

The Paris Conference was followed by other meetings over the next three years in Rome, Rabat and Luxembourg. And in autumn 2010, there was a Special Forum in Venice, on the beautiful island of San Clemente.

Over the years, the thinking of the Club has evolved. A Scientific Committee was established which initiated a series of joint working groups which have addressed subjects related to long-term investment. We have become aware of a number of problems. We have proposed solutions. The next Annual Conference is scheduled to be held in Brussels this autumn, when the new European government will have already been established. The subject of the Conference will, of

course, be "what to do?" and therefore the proposal of an Action Plan for the four years of the new legislature.

On 25 February 2009 the de Larosière Report² on financial supervision was delivered to European Commission President Barroso. It addressed, *inter alia*, the subject of accounting standards, claiming that the business models of intermediaries should be taken into account, especially if made up of long-term assets and liabilities; that the standards should promote pro-cyclical behaviour; and that long-term investment should be encouraged.³ In addition, in terms of corporate governance, a review was suggested of the financial remuneration system, in order to favour the interests (not short-) but long-term of the shareholders and of the company⁴.

In spring 2009, the EIB, together with the European Commission, at the request of the Commissioner for Transport and the Greek Vice-President of the EIB, delivered a proposal for a programme to support the subject of project bonds to finance the TEN-T and Ten-E projects. This arose out of the acknowledgement that the European banking system and the financial market were in crisis, and that the demand for debt of the major European infrastructure projects did not find a corresponding supply from the European banking system. This involved issuing bonds with an EIB guarantee for the realisation of the investment projects of the Lisbon Agenda in transport, energy, climate change and NGN. For the rest, both the EIB and the large European Banks finance directly, either alone or together with the commercial banks, the public utilities system, which in turn, produces a large part of the European investment in infrastructure.

It was to take a good four years to initiate the experimental phase of the so-called 'Project Bond Initiative'. Up to now it seems to be progressing successfully. Insurance and pension funding can be reserved in great numbers to buy the new bonds of the first projects to be funded. In the next few years we could see the emergence of a new market for these instruments.

In September 2009, the Club began to work on the subject of long-term investment with the Eurofi Think Tank, under the leadership of Jacques de Larosière, participating in the Gothenburg Conference during the Swedish Presidency. The authors of this report presented a paper entitled *New European Institutional Long Term Financial Instruments for a Strong, Sustainable and Balanced Global Growth* which emphasised the importance of investments made with long-term private funds and savings in the exit strategy from the crisis, thanks to their multiplier effect on the denominator of the public debt/GDP relationship. It was also argued that the EU should: initiate policies to create the right regulatory framework to attract long-term investors from Europe and the rest of the world; raise the credibility of the euro and the process of fiscal consolidation already achieved; "remove the dividend of the policies of austerity and good management of European public accounts"; create common financial instruments through the network of the large public national and multi-lateral development banks, in the area of risk, debt and guarantees; and introduce Eurobonds for growth and project bonds for infrastructure.

The intervention was greeted, as we recalled, with a certain "surprise", if not "coolness" by most of the participants. The exception was Jacques de Larosière who immediately grasped the spirit of the initiative and encouraged us to continue on the path of reflections on the long term. Already beginning in 2010, the subject of long-term investment was then included as one of Eurofi's basic principles, which without a pause became an important place of shared reflection between policy makers, economists and market operators, also becoming a staunch supporter (and a sounding box) of the rationale for the Club.

In December 2009, the CDP took part in a conference in another major European Think Tank *Confrontations Europe* led by Philippe Herzog (advisor to Commissioner Barnier) which

² *The High Level Group on Financial Supervision in the EU*, Chaired by Jacques de Larosière, Brussels, 25 February 2009.

³ "Accounting standards should not bias business models, promote pro-cyclical behaviour or discourage long-term investment" (Recommendation 4).

⁴ "In view of the corporate governance failures revealed by the current financial crisis, the Group considers that compensation incentives must be better aligned with shareholder interests and long-term firm-wide profitability" (Recommendation 11).

together with the LTIC would, in later years, strongly support the subject of long-term investment.

On 9 May 2010 the so-called 'Monti Report'⁵ was delivered to President Barroso in which the subject of long-term investment and the need for a regulatory framework capable of attracting private capital to finance these investments became central to the debate on the strengthening of the single market and of the search for an exit strategy from the crisis. A series of European Commission communications followed which also supported the need to sustain long-term investment to stimulate growth, employment and fiscal consolidation, as well as to set out a more favourable regulatory framework for those investments.

Even the subject of overseas long-term investment attracted the attention of scholars and financial operators. At the *Center of Global Thought* at Columbia University, chaired by Joseph Stiglitz, the first of a series of conferences was held in October 2010 entitled, *Sovereign Wealth Funds and other Long-Term Investors: A New Form of Capitalism*. On our part, we presented a paper entitled "Financing Long Term Investment after the Crisis: a View from Europe", which received unexpected interest among American economists who saw in the long term oriented social economy of the European market a model to "brake" the short-termism and the American financial industry's tendency to speculation.

Obama's America had a much more obsolete system of infrastructure than the European one. The Obama Recovery Plan in 2008 had allocated a further 800 billion dollars in these areas, through a panoply of different instruments and interventions (from guarantees of tax incentives to grants).

In 2009 the leaders of the EIB were received by the U.S. Treasury to evaluate whether to establish an American Infrastructure Bank on the model of the EU large multilateral bank. At the same time Obama launched a Project Bonds plan known as *Build America Bonds*, BABs (which enjoyed significant tax incentives which made them more attractive than State securities or municipal bonds - it must be said, incidentally, that the issue of BABs are a method for the very indebted municipalities market to avail themselves of additional finance in municipal bonds without increasing the local debt as project bonds are not consolidated in the debt of the municipalities. In only 18 months the BABs market reached 200 billion for investment in infrastructure.

On the 2 May 2011 at a conference in Paris organised by the ECB and the EIB, the leaders of the founding members of the LTIC held a meeting with Mr. Mario Draghi, Chairman of the Financial Stability Board (FSB), during which they raised the subject of the relationship between the business model of the various long term institutions and the mark-to-market philosophy which is the foundation of the International Accounting Standards (IAS). Draghi immediately grasped the point and assured us that he, in turn, would have brought the matter to the attention of the FSB. A few years later, upon the order of the G20, the FSB produced a report on the topic of the LTI in which the question that we then had raised with Mr. Draghi was discussed for the first time. The subject is of course still open. A special LTIC Working Group is talking with the FSB. The question is whether it is appropriate to introduce an additional category for financial assets which do not fall within the definition of amortised cost or in that of fair value through the category of the profit and loss account for financial assets which are on the books in the medium and long term. The hope is that this dialogue will provide solutions which do not penalise those institutions which have a business model based on long-term assets and liabilities (such as pension funds, insurance companies and Sovereign Wealth Funds, SWFs) or which operate on a long-term and the public interest mission (such as national and multi-lateral development banks). After all, the concept of "value in use" is already defined in IAS 36 - Paragraph 6: "Value in use is the present value expected from an asset." This definition could be extended to financial assets held by institutions which intend to keep them in the portfolio for a long period of time. It would prevent the main indicator for measuring the profitability of an asset from being distorted by short-term fluctuations. The experts, however, are well aware that,

⁵ *A New Strategy for the Single Market. At the Service of European Economy and Society*, Report to the President of the European Commission by Mario Monti, May 2010

although logical, such an address would find technical and ideological barriers difficult to overcome.

The Club, during the first two years of activity, worked primarily in the role of banks, commercial or otherwise, in the financing of the real economy and infrastructure. Since the outbreak of the crisis, Jacques de Larosière has reminded us that the European banking system is bank-centric, while the American is market-centric. So the Basel III "cost of stability" is much higher in Europe than in the United States.

In 2011, CDP raised this subject within the Club claiming the need to begin to investigate the role of long-term institutional investors such as pension funds, life assurance, and sovereign wealth funds in the financing of the economy and infrastructure, including bypassing the medium-term negative effects of Basel III on long term financing by Europe's financial system. We thus began to explore the subject of asset allocation of pension funds and insurance (subject on which the OECD, since 2009, had already begun to work) and the subject of Solvency II. We, I think, anticipated that a demand for long-term investment was being originated, which if it were to be satisfied, would have to be structured as a new "asset class." Today the subject enthral the financial market, which sees great opportunities for profit and/or stability in the origin of this new asset class.

In our first paper on the role of institutional investors in long-term investment, we also addressed the subject of the excessive weight that Solvency II would charge insurers to hold infrastructure assets, despite statistics showing that project bonds have a better recovery rate than project bonds, which instead require an expenditure of capital which is less than the loans for project financing⁶.

In March 2013 the European Commission adopted the "Green Paper on the long-term financing of the European Economy". The Green Paper represents an important step forward by the EU in recognising the importance of long-term investment. The majority of questions asked by LTIC in the following years are taken from the Commission's document.

The Report on SME and European infrastructure financing went to print in December 2013. It was prepared by a High Level Expert Group at the request of the Irish Presidency of the European Union. The EU reached the turning point in its reflection on long-term financing in Europe.

On 14 April, 2014 the European Parliament voted on the Report for constitution of the European Long-Term Investment Funds (ELTIFs), which was proposed for the first time on 26 June 2013. This involves creation of a European fund for financing Small and Medium-Sized Businesses and other long-term investment. One of the subjects widely discussed at present is the possibility that retail investors may also have access to the Fund. In reality, even if it may be too early to say so, ELTIF looks very similar to the Delors Eurobond project for growth.

Finally, in the spring of 2014 the EU published a Communication known as "Action Plan for Long-Term Financing of European Economy", indicating the challenges of the European political agenda in terms of long-term financing for the next legislature. As we will see, the upcoming six months of Italian Presidency will probably be concentrated on these challenges.

In parallel, the awareness of the importance of long-term investment spread on the global level and was finally included in the G20 conclusions of the Russian Presidency in September 2013. Also, the Australian Presidency of the G20, which has followed the Russian one, has emphasised this subject, in particular in terms of infrastructure.

Finally, as of 2009, OECD has been involved in a project for obtaining data and conducting studies on the role of institutional investors (pension funds, insurance companies and SWF) in the financing of long-term investment. In 2013, the OECD created a task force, which drafted the "Principles of Financing of Long-Term Investment" by institutional investors, approved by the G20.

⁶ F. Bassanini, G. del Bufalo, E. Reviglio, *Financing Infrastructure in Europe Project Bonds, Solvency II and the "Connecting Europe" Facility*, article prepared on the occasion of the "Eurofi Financial Forum 2011" which was held in Wroclaw, on 15-16 September 2011, during the Polish Presidency of the EU

The Club has worked from the beginning in close contact with the OECD on long-term investment. Among international institutions, the OECD has made the most convincing and important contribution with the creation of databanks, publications and congresses. Due to the interest, the Russian presidency of the G20 in 2013 and the Australian presidency in 2014 have placed the issue of long-term investments on the agenda of the upcoming G20s, involving the World Bank, the International Monetary Fund and the FSB, LTIC and the OECD in preparatory work.

Long-Term Investment

To make growth sustainable and to distribute evenly its benefits, it is necessary to strengthen long-term investment. A lot has been written about this and I would not like to repeat things we already assimilated.

The search for a scientifically rigorous definition of “long term” has already resulted in extensive literature. Amongst the many suggestions, I would like to limit myself to a short summary of the definition recently developed by the OECD.

The concept of “long term” refers to financing with a duration of at least five years. The definition is not limited to the duration, but also includes the condition that investment must be relatively stable in time. It identifies a set of criteria, which institutional investors may use to identify them:

- (i) They constitute a *productive capital* supporting infrastructure financing of “green” growth and financing of small and medium-sized businesses;
- (ii) They are *patient capital* permitting investors to have access to a so-called ‘illiquidity premium’, rarely requiring refinancing, they contribute to the reduction of diffusion of pro-cyclical investment, assure net rates of return on investment that are non-speculative and stable in time, assuring a higher financial stability for the investor;
- (iii) They represent *dedicated capital*, encouraging active voting policies, which in turn improve the quality of corporate governance.

Financing of Infrastructure

Infrastructure are characterised by certain idiosyncratic features, typical for newly constituted markets. The financial offer is abundant but the pipeline of bankable projects is still narrow, even in the most advanced markets, such as the European market.

One example is sufficient: one of the largest Greenfield funds, operating in Europe decided to co-invest in equity in only 9 of about 500 analysed projects in the sector of energy and transport in the last two years. For some other funds operating in Europe the ratio of projects analysed and projects, in which it was decided to invest, is slightly higher, but in any case remains particularly low. This is worrying and means that progress still has to be made to launch Private Public Projects PPP in Europe. In fact, there are few “investment grade” projects in the pipeline, i.e. projects that are not only bankable but adapted to more prudent categories of investors on the capital market, such as pension funds and

life insurance. This means that there are subjects or processes representing “weak links” in PPP projects. The complexity of construction and financing or major projects, especially in sectors with high technological content or with high regulatory or macro-economic risk, requires agreement with various entities working together like an orchestra, and not for a short period of time, but in many cases for 30 or 50 years. For example, the public sector is still often a weak link in the orchestra.

Technological and environmental risks, as in the case of tunnels or dams, may be very difficult to predict and therefore to quantify. To finance this type of project, such as medium and large Greenfield projects, the financial products that may be of interest for long-term funds are for the time being limited to risk capital quotas in individual projects (so-called alternative investment in fund portfolios), possibly together with private equity funds with an established reputation, playing the role of anchor investor; bond projects guaranteed by EIB (in this case the guarantee and the illiquidity premium justify a higher yield); and co-participation in project debt together with other intermediaries, usually banks or other funds or insurance companies.

Long-term investment is usually reserved for pension funds or large insurance companies, capable of creating an “independent evaluation capacity” independently. This means creating or acquiring a market team capable of evaluating investments with the same capacities as private equity funds. Many funds and smaller insurance companies usually do not enter this market. In some cases smaller funds or companies create alliances, sharing the cost of external analysis capacity. Therefore, in general, the new model of non-banking infrastructure financing would require the creation of a new category of intermediaries, capable of discussing with the project company and project management on behalf of institutional investors.

The same type of scheme applies to medium-size and large Brownfield projects. However, the competences required are different and the yields are lower since the construction and operating risk is not included. In general, the demand of investors is high, much higher than for Greenfield projects.

We must note by the way that all this refers to the project financing market, which represents only 10% of all infrastructure financed in Europe. The remaining 90% is financed either by corporate financing or by general taxes. In this last case the Government pays the entire cost of the project through general taxes. In the former, on the other hand, companies guarantee the risk with their balance sheets. In this case investors may invest in corporate stocks or bonds issued not by individual projects, but by the company building the infrastructure.

The global infrastructure market financed directly by project companies represents slightly less than 500 billion euro (Dialogic data, 2013), 2/3 of which in Europe. If we consider mean fundraising of 80%, 500 billion of project finance risk capital is equivalent to approximately 2,500 billion in work financed at global level (including 2,000 of debt). As an example only, this amount can be compared with approximately 90,000 billion of assets managed at global level by pension funds, insurance and sovereign funds.

The situation is different for smaller PPP, for example social infrastructures (hospitals, schools, day-care centres, subsidised housing), energy or other infrastructure, but still of medium or small size.

If we also want long-term institutional investors to be able to purchase this type of project, it is necessary for the projects to be standardised and collected in dedicated portfolios. This poses some challenges, which should be at the centre of EU and member states' policy actions in terms of long-term investment, especially in Continental Europe.

Perhaps it may be useful to mention the new scheme of school construction in the United Kingdom, using new generation schemes in a country where PPP was born and has been developed with some success.

In short, the scheme is as follows: the process is centralised and managed for the public sector by the Government. Each Special Project Vehicle SPV builds groups of nine schools, called batches. The Government pays an availability fee for thirty years to each SPV (a sort of financial lease). The batches are then bundled in portfolios, issuing shares of 2-3 billion each, which at that point are acquired by the capital market, entering into the portfolios of institutional investors.

The EU encourages member States to finance investment using this type of structure, but the process is slow in taking off.

Why are there still so few standardised PPP operations, combined in single portfolios, conducted in many states of the Union?

There are many reasons and some of them depend on the country. A fairly common problem is the absence of technical capabilities of public administrations compared to contractual schemes, especially if they are not standardised and are very complex. Ad hoc agencies, which many governments constituted to provide technical assistance to administrations, turned out to be generally inefficient.

The PPP investment policies must be reconsidered and re-launched in the European agenda with extreme decisiveness – but to become successful what should the new model be? What do we need to do? First of all it is fundamental to centralise and standardise the PPP schemes. Considerable human resources (teams of experts) must also be invested to start the process, which is the only solution to the problem of reconciling high public debt, high social costs, low growth and high demand for investment, which will characterise European economies for the next decades.

Two more considerations regarding the PPP market in the EU.

The first one refers to the Eurostat rules on PPP. If, as it appears, Eurostat intends to acquire the IPSAS 95, which are international public accounting standards, all PPP operations will be consolidated in public debt (as already happens in the United Kingdom). This removes what used to be a strong incentive for financing public works with PPP, and namely the possibility of financing works without increasing public debt. In the ESA 95 version the accounting approach to the PPP initiatives was as follows: if at least two of the

three project risks (construction, traffic and rates) are transferred to the private sector, the financing of the project can be de-consolidated from public debt. This represents a strong incentive, and in part also leads to distortions, to finance work as PPP instead of direct financing with long-term bank loans.

This consideration leads me to the next one. Carrying out a project as a PPP is efficient if it is true that it represents more value for money. This is because the scheme is virtuous and the propulsive push of private entities permits building better infrastructure at lower costs. According to the specialised literature, however, this statement, is at least controversial.

On the other hand, with public debts that are so high, and will probably remain high for many more years, the future of infrastructure financing in Europe must necessarily involve a change of model. In my opinion, the new model could be that of “institutional capitalism”, technically very expert, capable of increasing the efficiency through economies of scale by the means of standardisation, consolidation and privatisation of public service companies, through creation of dedicated national funds or a single fund or a European fund of funds (as proposed by the authors of ELTI), whose shareholders belong to the system of long-term institutional investors. The term “institutional capitalism” is used in this sense. The long-term objective should be to create listed public companies (national and/or European), operating in construction and management of public services and financing of infrastructure.

In the meantime, the solution to propose now on the European level to be able to finance the infrastructure, even through public debt, is a “Golden Rule” reserved for the work carried out as PPP and Lisbon Agenda works (TEN-T, TEN-E and Broadband). They are not included in the debt for the purposes of fiscal compact.

As for Italy – I would like to propose something. In the review that the Chairman of the relevant Parliamentary Committee is preparing to make for the proposed reforms of Title V (the part of the Constitution regulating the relations between the State and territorial entities), conditions ought to be created to bring construction and financing of public works via PPP to the centre, in a single agency or in multiple institutional funds.

Financing and the securitisation of SME loans

The crisis has weakened the ability of the European financial system to channel savings into productive investments. In general, in the countries hardest hit by the recession and the crisis there is a climate of uncertainty and risk aversion, which hinders their ability to invest, especially in the infrastructure and SMEs. Committed to reducing the lever to correct the excesses of the past, European banks have reduced their capacity to provide medium and long term loans. At the same time, the crisis has 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 concern. The corporate bond, securitisation and risk capital markets in Europe are still relatively undeveloped compared with other economies and the 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 of bank intermediation on 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 the institutional investors and non-banking financial markets. The development of the 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.

The evidence indicates that the financing conditions for SMEs in Europe are very difficult. The volumes of bank lending have been reduced in the last few years and 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.

The securitisation of SME loans has not regained strength after the crisis. This is partly due to the so-called "double-digit haircut", due to: (1) the need to increase the creditworthiness of asset-backed securities (ABS) in order to be eligible as collateral at the ECB and (2) to the "haircut" made by the ECB to such collateral in refinancing operations. It has been calculated that with 1 euro of an ABS they obtain 40 cents refinancing from the ECB. In addition, SMEs in the weakest countries will suffer the most, both due to the difficult economic and financial conditions, and due to the spreads related to sovereign risk.

The revitalisation of securitisation of loans to SMEs can be an initiative useful to undertake to "lighten" the banks and restart credit concession. The ECB has also supported the need to develop financial instruments which can be priced in a simple way.

In fact, securitisation in Europe is currently "frozen." To restart it, it would be necessary to act in three directions (see in this regard and for the proposal which follows, Jacques de Larosière, Eurofi, Athens 2014).

It is first necessary to restore investors' confidence. This means that the quality of bank lending must be beyond reproach. Considering the criteria already established by the central banks to accept loans to SMEs as eligible collateral and the ability of central banks to estimate the risks of these products, the definition of high quality standards for the securitisation market could be easily achieved.

On this basis, the Eurosystem could promote the development in each country of a European securitisation channel through which to acquire loans to SMEs which meet the "minimum" quality standards and would therefore guarantee the issue of "prime securities".

A second condition should be the provision of guarantees by the European and national development banks for securities issued by this institutional channel. Considering the high quality of these securities and government guarantees potentially provided, many investors may certainly be interested in investing, as they seek investment linked to the real economy.

Finally, the ECB, together with the national central banks, should be ready, if necessary, for temporary purchase of these securities in the form of Asset Backed Securities ABS to assist the launch of the securitisation market. This should be possible given the high quality of the loans affected by this proposal.

The Role of Long-Term Institutional Investors

The global industry of institutional investors is estimated by the OECD in almost US\$ 85 trillion. Today they invest around 2.5-3% of their Asset Under Management (AuM) in infrastructure (mostly in the form un-listed equity) equivalent to about US\$ 2.3 trillion globally. Potentially, as we have already seen, long term institutional investors' asset allocation in infrastructure could grow up to about US\$ 4.5 trillion (5% of total AuM). The goal is reasonable and the increase of resources for infrastructure quite outstanding in size.

Institutional investors are indeed facing a cultural change in developing direct investment programs in infrastructure projects. In this field, there are well known best practices in countries such as Canada and Australia.

In fact, among the 10 largest institutional investors investing in infrastructure in 2013, 4 are Canadian and 2 Australian. Out of their US\$ 1.6 trillion of AuM, these 10 largest institutional investors allocated roughly US\$ 89 billion to infrastructure assets, or about 5.5% of total AuM.

The 4 Canadian institutional investors accounted for US\$ 524 billion of AuM and allocated to infrastructure assets some US\$ 39.2 billion or in average 7.5% of total AuM (from 3.4% up to 24%), whereby the 2 Australian institutional investors accounted for US\$ 143 billion of AuM and allocated to infrastructure assets some US\$ 15 billion or in average 10.5% of total AuM (from 8% up to 14%).

Since 2009, through "Infrastructure Canada", the Federal government bolstered significantly infrastructure spending by means of establishing the Infrastructure Stimulus Fund, the Building Canada Fund as well as the Green Infrastructure Fund. As a consequence, the recent Economic Action Plan 2013 builds on the Government of Canada's investments with C\$70 billion for public infrastructure, including the C\$53 billion New Building Canada Plan to build roads, bridges,

subways, commuter rail, and other public infrastructure in cooperation with provinces, territories, and municipalities over 10 years, starting in 2014-2015. The Federal government is still committed to promote PPP investments, which account for 10-20% of total infrastructure spending in Canada. The Canadian PPP market is considered one of the most sophisticated in the world and is heralded as an exemplar in efficiency, with project timelines to financial close much more streamlined than both Australia and UK. This can be attributed to the centralized structures operating within the Canadian market, which ensured a greater level of proficiency and competence of the public sector. Although the Canadian bond market is very deep, the funding source and the technical form of financing is strictly related to the nature of the project. In Australia, significant infrastructure development was achieved over the past decade also thanks to an increased government funding and support by means of establishing a dedicated national body, “Infrastructure Australia”, as well as through innovative approaches for infrastructure deficit’s financing. As a matter of fact, mainly in the transportation and utility sectors, assets owned by the government can be easily and efficiently transferred to the private sector. In addition, fiscal incentives for infrastructure investments were introduced by the Australian government in order to attract private investors. These incentives, set up as indexed tax losses incurred in the early stage of infrastructure development, are expected to support up to AU\$ 25 billion in new private sector investments. The high level of financial market sophistication and transparency has fostered direct and indirect investments in Australian infrastructure. Investment indirectly through infrastructure funds or infrastructure based companies has gained momentum.

The Canadian and Australian infrastructure financing models are widely recognized as best practices and therefore the same models, or at least similar ones, should be replicated elsewhere. Viable project opportunities and a consistent pipeline together with a more proficient understanding of risk allocation, as well as tailored products for more effective liability matching, can definitely help to create a conducive environment for institutional investors’ appetite for infrastructure investments.

Risk-segregation in the different phases of projects should be considered, i.e. construction, development and managing. Each phase may need special financing actors, rules and instruments, with banks (both private and public) taking care of the first (construction) and the second (development) phases and the capital market, i.e. institutional investors, taking over the (longer term and lower risk) management phase of the infrastructure.

Therefore, governance risk management by long term institutional investors has to be reinforced to include also infrastructure financing. However, building internal capacity is expensive and needs a large dose of innovation in investments’ allocation strategies. As institutional investors expand and move into new geographies and sectors – particularly if they are trying to execute multiple transactions or overly complex transactions at the same time – a key

challenge is ensuring that they have built up, or buy, the right team and the best technical skills. Both resourcing and filtering the deal flow are challenges.

In general, however, financial markets worldwide are still relatively undeveloped when it comes to long term finance. Banks in emerging countries are building up their capabilities for project financing. The emerging economies capital markets too are not as developed as they are in the most advanced countries. The market for project bonds and hedging instruments such as long-dated currency swaps is not deep and the instruments not as actively traded.

Moreover, there is the necessity to develop stronger pools of institutional investors in emerging markets. Now only less than 20% of total institutional asset at the global level are coming from the emerging economies. With such high rates of economic growth, however, middle classes in the developing world are poised to expand substantially in terms of both absolute numbers and the percentage of the population that can claim middle-class status during the next 15-20 years.

Emerging countries' governments are themselves developing their capabilities to structure private-public partnerships and tenders in a bankable and sustainable fashion. This should not be a limiting factor; but it will take some time before it is developed.

In general, most countries in advanced as well as in emerging economies are working to catalyze the development of infrastructure finance. This will probably produce a large capital intermediation between advanced and emerging economies and growing global competition to attract capital investment.

The Role of Development Banks

New instruments and new agencies (MDB and NDB) are 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, for example, on the debt side, the Project Bond Initiative goes in this direction; while on the equity side, long-term infrastructure funds such as Marguerite could be used as "prototypes" for broad "families" of long-term funds for investment in infrastructure, technology, R&D, SMEs, start-ups, local utilities, energy, urban development, health care compensating for the general shortage of risk capital engendered by the crisis.

While waiting for a return of stability in the European banking system, the role of large national and multilateral development banks (EIB, KfW, CDC, CDP, etc.) has become increasingly important. New financial instruments have been designed; additional resources have been mobilised 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 capitalisation. Cooperation between these institutions could lead to further new initiatives and new instruments.

Global financial markets are indeed 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). Development 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); not tainted by financial crisis abuses; known as carefully structuring transactions; in-depth local knowledge; benefit from preferred creditor status; have political weight, have delivered returns consistent with risk (and market).

Among the new instruments which may need to be reinforced by Governments' agencies, MDB and NDB, 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, it should be reconsidered the securitization of lending as well as new issues of capital market debt. According to Standard & Poor's, since 1998 the average default rate for all project finance debt was much lower than that of corporate debt. In addition, although defaults among corporate borrowers increase at the height of the global financial crisis in 2008-2009, project finance transactions remained resilient, with an annual default rate of about 0.5%. On top of that, project finance debt also delivers a better rate of recovery when defaults do happen. The average recovery rate across S&P's rated project finance portfolio is about 75%, with most lenders receiving close to 100% and very few getting shut out entirely. This compares with an average of about 45% among corporate borrowers. So, there is no doubt that infrastructure bonds (via securitization of lending and/or new issue of capital market debt to project finance initiatives) could become quite attractive for institutional investors.

The European banking system: towards a return to normality?

The redevelopment of asset quality reviews (AQR) and their stress tests should speed up the restructuring of the bank balance sheets. This year could be a turning point in the process of cleaning the bank balance sheets, thanks to the planned capital increases. The banking union with its related mechanisms are an important step in overcoming the banking crisis, providing the economy with a banking system which can finance it.

The ambitious financial system reform programme has the dual objective of: (i) making the institutions more robust and less vulnerable to any financial market

shocks (ii) breaking the risk transmission vicious circle between bank assets and sovereign securities in both directions, from bank assets to sovereign securities and vice versa from sovereign securities to the banks.

The redevelopment of the asset quality reviews and the relative capital stress tests should definitely complete the restructuring of the bank balance sheets. So this year (as early as the second half of 2014) could represent a turning point.

With Basel III, in the name of stability, a new system was built which required a profound adjustment. The heaviest price was paid by the financing of the economy, especially medium and long-term finance, such as infrastructure and SMEs.

Seven years after the start of the deleveraging process and balance sheet restructuring under the new Basel III rules are we, therefore, perhaps at a turning point? There are different positions on the subject.

Some believe that the system will return to financing the deserving economy to pre-crisis rhythms quickly enough.

Others, like Jacques de Larosière, argue that the capital and liquidity requirements imposed by the CRD IV directive will tend to significantly reduce the banks' profitability. This will reduce commitments characterised by contained margins (risk-adjusted), such as for example those associated with the financing of the SMEs.

The idea is that the reduction in the levels of profitability will make it difficult for the banks to find "additional" resources to fully meet the capital requirements. The more profitability is limited, the less possible it will be for the banks to set aside new reserves and, therefore, to raise capital. In this situation, compliance with the objectives related to capital requirements and liquidity can be achieved only through the reduction of assets, including loans.

In general, it is feared that even if the European banks are able to pass the tests, they may be very cautious because they perceive a real risk of a triple-dip recession.

What actions should be taken to accelerate a rapid return to normal? Restarting the securitisation process, focusing on that of the SMEs, as we have seen, could give valuable assistance to the deserving SMEs and the banks.

In Italy, a bond market for SMEs is developing through the creation of debt funds. A solution which facilitates the disintermediation process of the banking system and encourages a greater use of the capital market. Recent estimates of the Standard & Poor's agency predict that the share of bonds in the total funding of Italian SMEs can rise to 15-18% over the next four years. A remarkable share, if it were to happen, and relatively quickly.

Proposals to encourage long-term investment in Europe: an overview

A common European policy is necessary for the promotion and support of long-term investment to strengthen economic growth and competitiveness and at the same time to attract capital from the private sector.

The main pillars of this strategy should be the following.

Firstly, the definition of a regulatory framework more "favourable" to long-term investment. Currently, the main accounting rules and supervisory requirements (Basel III-CRD IV, Solvency II, the IORP, IFSR) still tend to favour the short-term and penalise the long-term investment. CRDIV has passed to the launch of the Parliament. Realistically, recalibration could be contemplated a little later in time (especially in terms of the ratio of liquidity and capital absorption for certain asset classes). There is still a space, even if small, on Solvency II, to obtain a more favourable treatment to long-term investment. Pension funds will, it is hoped, capitalise on the work done by insurance to obtain some significant changes. Generally, if there is a strong interest from the market and a strong support by the Governments to create a new "asset class" represented by the infrastructure and, more generally, by the long-term investment, it will mean that some major changes are inevitable. Regarding IAS in relation to the business model, as we have already said, the road seems to be now rather "uphill".

Secondly, tax systems, which have a direct effect on investment decisions and on savings. More generally, taxes may be used to correct externalities that come from market failures. This is the case for project finance for infrastructure. Corporate taxes in most countries tend to favour debt to risk capital, thus creating generally higher incentive leverage relationships. Interest rates are, in fact, deductible, while returns from capital are not. Financial deleveraging should be an important goal of economic policy. Savings taxation can change behaviour, allocation of capital and investment. Many States have introduced incentives to increase (long-term), savings as occurs, for example, on retirement savings. Finally, tax incentives may encourage PPP. There are strong reasons in favour of such incentives. On the one hand, in fact, they make it possible to make investment which would not otherwise have been made because they needed public resources; on the other hand these investment contribute positively to growth and thus to fiscal consolidation.

This is an incontrovertible fact, at least in all those cases in which the incentive is strictly directed to re-balance the financial plan of work which had suffered an adverse effect from the cancellation of subsidies or an increase in the cost of bank loans. It must be limited to that higher portion of taxes collected, generated from investment, net of substitution factors.

It should not be forgotten, finally, that we must avoid the tax incentive contributing to distort the risk assessment.

Thirdly, at European and national level, much remains to be done to have an investment friendly regulation, and to reduce risks and regulatory costs. Political and legislative stability, streamlined and fast administrative procedures, regulatory and bureaucratic burdens contained, a fast and reliable

judicial system, an efficient and technically prepared public administration are known to be decisive factors in investment decisions, which today have the entire globe as their horizon. Despite some recent progress, in many European countries, the quality of regulation and regulatory risks remains one of the major obstacles to the ILTs. In the European administrative space, which has finally found a legal basis in the Treaty of Lisbon, it is now possible to envisage a European better regulation policy, looking to ensure the convergence of European and national regulations towards investment-friendly models.

Fourthly, I would like to propose the establishment of a Very Long-Term Refinancing Operation (VLTRO) by the ECB. To combat credit rationing in the medium to long term, the ECB might want to consider an exceptional refinancing on the model of two recent LTROs, but with three important differences: a longer duration (6-9 years), a smaller amount (150-200 bn would be enough) and a definite constraint on the financing of ILTs (infrastructure and productive investment)⁷.

Under certain conditions, the same investment projects may be accepted as collateral, whether with co-financing from the EIB (and therefore validated technically and financially), and if backed by government guarantees (or a system of safeguards built jointly by the European development banks together with the EIB).

Condition for access to this Very Long-Term Refinancing Operation (VLTRO), should be deposited at the ECB financing contracts in the medium to long term, to which the ECB funding would be allocated.

Conclusions

In the last four year much progress has been made in the evolution of the concept of long term investment for the exit strategy from the crisis and for the debate on a new economic model of development after the crisis. Not only in Europe, but throughout the world. The concept of long-term financing of the economy is on the agenda of governments, large international organisations, national and international regulators, the G-20, the market and the European Union (EU). In Europe, in particular, the Commission has produced an "Action Plan" which contains the *road map* for the next European legislature. It contains a series of clear directions. For some there is a broad consensus, others less so. Some technically easier, others harder. In general, however, the market, the banks and businesses are on the starting line and pushing for many of the proposed initiatives to be started. The governments and the EU are aware of this and recognise its urgency. The Italian Presidency of the European Semester will have the task of guiding the process from one European legislature of the European Parliament to another. After four years of words (and some deeds), it is high time to move on to deeds.

⁷ See F. Bassanini, *Financing long term investment in Europe: the case of project financing, 2012 OECD Forum Policies for a new infrastructure investment model*, Paris, 23 May 2012, now in *Astrid Rassegna*, no. 11/2012