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The role of long-term investors to support growth in the context of deleveraging and fiscal discipline¹

Ladies and gentlemen,

we are here tonight for the 4th International Conference of the LTIC in a **crucial moment for the European economy**. A worsening of the Eurozone crisis is broadly perceived as a downside risk for the global economy, with relevant impacts on other major economic areas, from Asia to North America. The **Euro group** Ministers have established a permanent ESM, with a capacity to intervene up to 500 billion euro. Together with the measures recently undertaken by the ECB and some national governments, it is an important step which can support financial stability. However, the economic situation remains extremely difficult and calls for a vigorous answer from the ones that can contribute with actions supporting the economic recovery.

Within this framework, the **role of long-term investors** is fundamental to restore economic growth and competitiveness, to assure the sustainability of the budget consolidation process in the medium term, and therefore, even, to support the financial stability.

The financial crisis and the European banking system

1.- After the crisis, the advanced countries – and particularly the European countries hit by a double-dip recession – are running large government budget deficits and are dealing with worrisome high public debt . Due to the fiscal consolidation policies, governments in those countries are no longer able to easily provide the financial resources to be invested in sectors like infrastructure, renewable energy, SMEs,

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R&D, etc., which are crucial to sustain growth and productivity in the long-run. Due to the same budget constraints, governments are facing enormous difficulties in introducing counter-cyclical policies to stimulate the aggregate demand, spur the economic recovery and mitigate unemployment.

At the same time, the **financial crisis**, the new regulatory framework and the resulting deleveraging process, are **undermining the functioning model of the European banking sector** and limiting the commercial banks' capacity of long-term lending. Four are the major issues that 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.

First, regarding Basel III capital requirements: recently the European Banking Authority (EBA) released its final report on EU-wide recapitalization exercise. Overall, the exercise led to an increase of **banks' capital positions** by more than 200 billion euros. However, there is consensus now - among major banking analysts - that the capital shortfall is still around 350-400 billion. The need to improve capital ratios, when capital increases on the market is burdensome, might entail an high risk of deleveraging, with banks reducing their more expensive assets in terms of capital requirement.

In addition, Basel III does not help² with its new **liquidity ratios**³ (although now under revision), which are, of course, very important for the financing of the

² 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.

³ 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 ($\geq 100\%$); 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.

investments. Financial analysts⁴ 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.

Second: **funding conditions** for European commercial banks deteriorated in late 2011. 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 economy⁵, and in certain cases had depressive effects on some banks' share prices (reputational effects).

Third: many (large) European banks still need to undergo a serious **cleaning up of their balance sheets**. 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 healthy, but , at times, a painful and difficult process.

Before the crisis, the European banking system financed around two thirds of the debt share of the **project financing initiatives** (PFI) worldwide. The long-term institutional investors (LTIs) backed around 40% of the long-term (LT) bank financing for infrastructure (through corporate and structured bonds). Since the beginning of the crisis this picture has been changing. In the last quarter of 2011, indeed, loans for project financing dropped by 39% for the so-called weaker EU banks and by 18,3% for other EU lenders, according to recent BIS data.

The combination of the economic slowdown and of the increasing difficulties in the funding conditions has been particularly harmful for **European private firms** as

⁴ 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.

⁵ It has been estimated by the BIS that, out 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-deposited 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 and infrastructures.

well. According to the latest statistical data by the ECB, the growth rate of the banking loans to companies in the Eurozone (which was positive and equal to 1.2% in 2011) turned into a negative value of -0.6% in the second quarter of 2012. Medium and long-term lending is suffering the most (-2,7% for lending from 1 to 5 years). The deterioration of the credit conditions is impacting much more negatively on financing capacity of the EU **small and medium-sized enterprises** (SMEs), especially in the southern Europe countries. These face interest rates higher than those charged to greater corporations, and the difference between the two rates is still increasing (according to OECD data).

In addition, capital requirements introduced by the new banking regulation framework could make loans to SMEs less attractive for banks than loans to bigger companies. As a result, 20% of SMEs perceived a further deterioration in the supply of bank loans during the last year, according to the last ECB Survey on the Access to Finance of SMEs in the Euro Area. In contrast, only 4% of **large firms** were affected by the deterioration in the availability of bank loans, down from 10% in the previous survey period. Overall, large firms were able to avoid the worsening in the bank financing conditions in the past months. A newer and stronger credit crunch could therefore be particularly damaging to the European economy, where SMEs are crucial engines of growth, jobs and social cohesion, given that they represent over 95% of all firms in many European countries.

In short: the state of European banking industry is under severe stress and this will penalize especially long-term financing to the economy and infrastructures 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?

Of course, it is unlikely that the European financial systems will change radically 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, still a mostly bank-based system.

The increasing role of the Public Development Banks

2. - In any case, while we wait for the European banking system to recover, the role of the long-term investors, like **public development banks (EIB, KfW, CDP, CDC etc)**, pension funds, insurance companies, will assume and is already assuming an increasing importance. Over the past few years, the mission of many of our institutions, members of the Long-Term Investors Club (LTIC), has become progressively broader and more complex. We have introduced many new instruments and devoted a considerable amount of resources to support the economy in this period of crisis, first of all by financing infrastructures and SMEs.

Most of **our institutions** have already established equity (and mezzanine) **funds**, especially **targeted to SMEs**. Many of us have also established debt instruments, like special funds, to provide the needed liquidity to the national banking systems in order to lend at better conditions to SMEs. These initiatives had a very positive effect, easing the credit crunch that SMEs experienced during the financial crisis.

Our institutions do also play a key **role in financing infrastructure**, both at the national and the international level. Let me only mention here the two private equity funds, **Marguerite and InfraMed**, which involve many members of the LTIC and invest in infrastructural projects related to the transport sector, to renewable energy and logistics. In particular, these funds support those sectors that have a major impact on economic growth and social cohesions, like water, waste, renewables, gas, ports, hospitals, etc.

We are already working with the European Commission and the EIB on the **project bond initiative**, to identify a feasible way to expand the tools available for infrastructure financing in Europe. This instrument, is not a panacea. However, it can represent an useful complement and an interesting investment opportunity for many institutional investors worldwide willing to increase their share in infrastructure financing.

At the same time we are exploring other ways to support infrastructure financing, for instance the possibility of pooling risk, developing joint financing or investment initiatives and even creating one or several common debt funds, building on the expertise of our institutions in this field.

Summing up, we are strongly committed in working together to enforce and develop the financial instruments consistent to our mission of Long-Term Investors, in a period in which the financial turmoil and the sovereign debt crisis are severely stressing both the banking system and the public finances.

Regulatory and policy actions needed to enhance the Long-term Investment

3. – Of course we cannot do this job on our own and we are not interested in doing it alone. We strongly wish that other LT Investors could join our efforts. Other long-term institutional investors in search of appropriate financial instruments/assets to match the duration-gap implied in their business models, such as life insurance and pension funds, have been historically the main providers of LT financing.

To support our and their efforts, strong policy actions able to enhance the LT investment and the long-term financing of SMEs and infrastructures are needed. A number of actions have been already taken. But **much more should be done** in the near future, in the following directions: (1) re-calibration of prudential and accounting regulatory framework (2) structuring of new EU LT financial instruments (3) mitigation of non-regulatory risk (4) introduction of fiscal incentives and other regulatory incentives, and, perhaps, (5) a specially dedicated non-conventional measure (VLTRO) by the ECB.

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 LT Investments. and dampen the holdings of long-term assets by insurance companies and pension funds. It is not a question of easing the financial stability framework, but to find appropriate fine-tuning solutions to 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. We need special regulation for the special business model of our institutions and for the other long-term investors.

The definition of a new regulatory framework friendlier to LTIs has been suggested by the Jacques de Larosière and Mario Monti Reports, by many papers written by authoritative experts and by the European Commission in the Communications on “*A New Single Market Act*”⁶, on “*A Comprehensive European international investment policy*”⁷, and on “*The EU Budget Review*”⁸. But, notwithstanding this broad consensus on the need of a new regulatory framework more favorable for LTI, the international and European regulators seem to be too 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 European Energy Efficiency Fund - EEEF) 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 Southern Europe, a huge equity crunch and a great need for LT equity to stimulate LTIs in the economy

On the debt side, as I mentioned before, the large national development banks (EIB, KfW, CDC and CDP), may consider to join forces to create one or several funds for debt (backed by guarantee schemes) for infrastructure, for SME's and, more generally, for LTIs.

Within such context, the EU Project Bond Initiative, together with the EIB, becomes key for the financing of infrastructure investment and the European recovery. A new market of EU Project Bonds and the scaling back of bank lending to this sector

⁶EUROPEAN COMMISSION COMMUNICATION, *Towards a new Single market Act*, 27th October 2010 – COM(2010)608.

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

⁸EUROPEAN COMMISSION COMMUNICATION, *The EU Budget Review*, 19th Oct. 2010, COM(2010) 700.

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, first of all, **good projects** to be financed and adequate skills and experience to assess their feasibility and profitability. It requires as well 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**. They may serve both growth and fiscal consolidation objectives, when the incentive is needed to rebalance investment projects no more supported by budget resources and if the incentive is limited to a share of the new fiscal revenues actually and directly produced by the new investment, net of substitution effects. Tax incentives should be provided also to promote **long-term saving and long-term shareholding**.

Fifth: to support PF and PPP initiatives, the ECB may take into consideration a **6-9 years LTRO**. The two previous 3-years LTRO tackled successfully the short-term liquidity crisis. A very long-term refinancing operation (VLTRO) of a much smaller size (100/150 billion) could be successful to overcome the present medium/long-term funding 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 LT Investments. This new type of ECB facility may be granted only to public development banks (EIB, KfW, CDC, CDP, etc.) or to all European banks. <the projects to be financed should be fully bankable, following a satisfactory due diligence process.

The contribution of the LT Investors Club to promote growth and overcome the financial crisis.

4. – To conclude. LT investments are fundamental to overcome the financial crisis, to assure long-term financial stability, to enhance growth and competitiveness.

Today, the financing of LTIs cannot be assured, as in the past, mainly by public resources and by banking lending. Our role has become crucial and we must be able to face these responsibilities also developing new tools and innovating our working methods and business models.

But relevant changes are needed also in the EU and MS public policies and regulations, in order to support the European financial industry in fostering LTIs and to make European project financing attractive also to non-European investors.

The **Long-term Investors Club** can act as a catalyst in financial cooperation. Our Club was created in 2009 to promote LT investment at a global level and to encourage **cooperation** among members. We are today 15 institutions with a balance sheet of 3.8 trillion. It represents an unique platform to exchange views, practices, business opportunities and to focus on relevant topics of common interest. Our diversity, in terms of geographical coverage and kind, provides an exceptional range of prospects. After a few years of outreach we are identified as a relevant actor on long term financing.

At the EU level, the **European Commission** has recognized the relevance of LTI for growth and is now preparing a “**Green paper**” on conditions and instruments to stimulate the financing of LT investment. I am sure that we shall contribute constructively to this debate and provide concrete proposals.

At the **global level**, the **G20 Russian Presidency seems willing to choose the LT investments as a core topic of the 2013 G20 agenda**, together with energy. IT seems to me an unique opportunity to establish a steady link with this major economic policy forum. We should not forget that the first G20 Leaders’ Summit in Washington in 2008, while setting the guidelines for reforming financial regulation as we know it today, did not pay much attention to the possible role of LTI in supporting growth, and this lack of attention was – I think – one of the main reasons of the transformation of a financial crisis in a double-dip recession. With the active role of our Russian partners of VEB, and using our well-established cooperation with the OECD, we could offer to the Russian presidency the support of our experience and proposals in the field of LT Investments.

Let me conclude with a short reminder of the political philosophy which characterize our institutions. We are market units, but we are “policy driven” not only “profit driven” institutions; we are “market conform”: not in competition with the market but “complementary” to the market; we support the market for a sustainable and long term growth of the economy. In Europe we are essential tools of the special model of capitalism, based on the social market economy, formally entrusted in the Lisbon Treaty.

We did not need the crisis and its lessons to understand that in the modern market economy free competition must be coupled with good rules and forward-looking public policies, both able to assure financial stability but, in the same time, to promote growth, competitiveness and social cohesion as well; and that strong LT investors are an essential tools of these policies.

We hope that the lessons of the crisis will now convince governments and international and EU regulators that a sustainable, balanced and durable growth cannot be a secondary objective, much less important than the financial stability and the budget consolidation; but that growth (and therefore the long-term investment) is a crucial need, and even a *condicio sine qua non* for a sustainable long-term fiscal consolidation and for a lasting financial stability.

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