



EUROPEAN
COMMISSION

Brussels, XXX
[...] (2012) XXX draft

GREEN PAPER

LONG-TERM FINANCING OF THE EUROPEAN ECONOMY

(Text with EEA relevance)

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1. INTRODUCTION

The financial crisis has badly harmed the European economy. Europe's most pressing priority now is to reinstall confidence and put the EU back on the path of smart, sustainable and inclusive growth, creating jobs, building on its areas of competitive advantage and, thereby, enhancing its competitiveness in the global market place.

There is no silver bullet for kick starting growth and competitiveness – determined effort is needed at all levels, both national and European, as set out in the European Council's Compact for Growth and Jobs¹ and the Commission's recent Annual Growth Survey.² Both have underlined the importance of an integrated European approach and the need to boost the financing of the economy: sustainable growth must be driven in large part by investment and innovation, which in turn should lead to a significant increase in productivity, employment and an increase in the long-run trend of economic growth. The importance of long-term financing has also been highlighted by the G20,³ recognizing the need to foster an environment more conducive to long-term investment.

Long-term financing of the economy supports structural economic reform and increases the stock of human, social and productive capital. It enables investment in the full range of productive assets, including major infrastructure investments; long-term industrial assets; large-scale mobile capital goods; social infrastructures related to changing demographic needs and education; R&D; new technologies to tackle climate change (including SMEs). All these require long-term investment which should be adequately financed at all stages of their development. It must also help in the financing of exports.

The capacity of the economy to finance long-term investments depends on its capability to generate and mobilise savings and attract foreign investments, as well as to channel the funds effectively and efficiently to the right users and uses. Public resources at both national and EU level play a role here, as evidenced by the objectives of the Multiannual Financial Framework (MMF) and by the role of the European Investment Bank (EIB). Encouraging progress has been made in several areas – for example, steps to increase the capital of the EIB by EUR10 billion are underway; progress is being made on piloting European Project Bonds,⁴ potentially

¹ See http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/131388.pdf

² See http://ec.europa.eu/europe2020/pdf/ags2013_en.pdf

³ See <http://www.g20mexico.org/index.php/es/comunicados-de-prensa/537-final-communique>

⁴ See: http://ec.europa.eu/europe2020/pdf/growth_report_en.pdf

mobilising up to EUR 4.5 billion in private investment; and, negotiations are also underway on the proposed growth-enhancing measures of the MMF Programmes for 2014-2020.⁵

However, the public sector is currently constrained by heavy indebtedness. At the same time, the weak macroeconomic outlook, low interest rate environment and potential investment risks mean that households and the corporate sector are faced with a climate of uncertainty and lack of confidence.

Despite a high level of savings in Europe, the promotion of investment projects is hindered by financial constraints: the current focus on liquidity and cash hoarding, combined with reduced incentives for long-term household savings, have either crowded out or tied up capital. In addition, banks – the biggest financial intermediaries in Europe – are undergoing necessary deleveraging. Many also claim that the financial intermediation chain has become too long and too complex, creating increased costs for end-users and potentially misaligned incentives, such as those arising from the bias towards trading and short-termism at almost every point in the chain. It is therefore becoming especially difficult in Europe to finance growth- and job-enhancing investments with long maturities.

Europe needs to enhance the financing capability of the economy including the incentives for long-term saving in a way which supports a convergence of the interests of both households and corporates. One main lesson of the crisis is that appropriate regulation and supervision of the financial sector has been necessary to restore financial stability and confidence in the markets. Financial stability is a necessary precondition of growth, but it is clearly not sufficient on its own. As we now seek to look beyond the crisis, it is appropriate to ensure that the detailed calibration of the new regulatory and supervisory framework fully enables the financial sector to support the real economy. The efficiency of the chain, which links savers and investors to firms seeking capital for investment, is critical to allocating capital to investments with sufficient profitability and delivering more added value in the medium and long run, raising productivity, and in turn, improving competitiveness. This is a challenging, complex and multi-dimensional task.

In particular, against the background of the structural changes underway in Europe's banking sector, it is important to consider what more could be done: to improve the ability of institutional investors, such as insurers and pension funds, and of financial markets to complement the role of banks in channelling finance to long-term investments; to ensure that the valuation of long term investment projects is adequate and that public policies effectively catalyse long-term saving and financing; and, to improve the access to finance of SMEs in particular.

Long-term financing supports investment in infrastructure development and renewal, as well as in industrial productive assets and social public goods. It is worth noting that for every 10 jobs created in industry, between six and 20 jobs are created in the rest of the economy.⁶ Long-term financing is also needed to help fund exports (e.g. through Ex-Im banks or export credit agencies), which in turn helps to improve trade balances. Finally, long-term financing is required to support research, innovation, and SMEs, through the injection of stable capital.

⁵ This includes including the Connecting Europe Facility (CEF), Horizon 2020, and a programme for the Competitiveness of Enterprises and SMEs (COSME). See http://ec.europa.eu/commission_2010-2014/president/news/archives/2012/10/pdf/20121017_en.pdf

⁶ See Communication "A Stronger European Industry for Growth and Economic Recovery"

All of this may occur at different stages of an enterprise's life, and while the source of this funding may evolve, the key aspect is managing continuous, smooth transitions.

The purpose of this Green Paper is therefore to initiate a broad and deep debate about how to address these complex, but pressing challenges. Responses to consultation questions for stakeholders from both within and beyond the financial sector will contribute to further assessment by the Commission of the barriers to long-term financing and how they can be overcome, with a view subsequently to identifying possible policy actions. This Green Paper is accompanied by a Commission Staff Working Paper, setting out the underpinning economic analysis in more detail.

2. CHARACTERISTICS OF FINANCING LONG-TERM INVESTMENT

In broad terms, long-term financing can be considered as the process of investing with the expectation of holding an asset for a long period of time by an investor with the capability to do so with a yield. Investors engaged in long-term financing are generally less concerned about interim changes in asset prices, and instead are focused on long-term income growth and/or long-term capital appreciation, both in their initial evaluation and continued interaction with their investments. Long-term financing is required by entrepreneurs, corporates and public authorities to fund long-term investments which entail high-level fixed costs and provide delayed returns. A relationship of trust between these economic agents, financial investors and markets is required at all stages of the investment cycle. In practice, there is no simple or single definition of long-term financing. Descriptions tend instead to cover a range of features, including:

- **The characteristics of the investor.** Pension and occupational retirement funds, insurers, foundations and sovereign wealth funds are typical examples of long-term institutional investors, although retail customers may also look for long-term investments. Investors' behaviour and decisions differ according to the nature of their short-term obligations; their assessment of the likely returns; their capacity to accept losses; and, their ability to execute a long-term investment strategy;
- **The nature of the asset classes that is appropriate for long-term investment.** Assets appropriate for long-term investment are likely to be less liquid, have long maturities that extend over the business cycle and yield first returns only after some years of investment. They are more exposed to changes in credit quality and inflation expectations, but less to market-price volatility, than assets with shorter maturities. They typically involve "patient" capital and intrinsic project and implementation risk. However, even very liquid assets (such as listed shares) can be appropriate for long-term financing, and, conversely, even long-term asset classes (such as bonds with very long duration) can be the subject of short-term trades;
- **The nature of the financial intermediation involved.** Long-term financing usually requires significant maturity transformation, as the majority of available funds tend to be short-term, whereas the subsequent investments are made over an extended time horizon, and it involves pooling of different sources of funds given the large size of investments; and
- **The nature of valuation and pricing of the assets involved,** which influences both investment decisions and their risk assessment. Pricing signals can pose a range of problems as some factors are not taken into account in price formation. Individual

investors usually do not consider wider economic social costs and benefits when deciding on long-term investments. The economic and social value of the assets may differ from their financial value. Similarly, accounting principles, benchmarks and credit ratings may measure only part of the value of assets and thereby introduce distortions into investment choices. In addition, the illiquid nature and long-term maturity of assets aggravate risk assessments over the life of investment. The approach to risk pricing by financial markets may also have an impact on the pricing of public investments. In the run-up to the crisis, financial markets clearly underestimated risks, raising questions about the adequacy of risk assessment systems. Finally, increasing uncertainty over long-term interest rates could further hamper long-term investments.

Question:

Do you agree with this characterisation of long-term financing?

How can the relationship between investors, markets, and the economic agents be improved to enhance the continuity of financing cycles?

3. INVESTMENT NEEDS AND DEMAND FOR LONG-TERM FINANCING

Long-term financing must support today's economic, social, environmental and demographic investment needs. Long-term investment also contributes to increasing global demand and sits at the heart of the added-value chain. In broad terms, the provision of long-term financing is key for any strategy aimed at enhancing competitiveness in the EU through addressing investment needs for both industry and public goods. It plays a key role in supporting investment including in:

- R&D and innovation, education and professional training;
- Infrastructures, including transport, energy and communication networks;
- Industrial technology transformation and capital-intensive projects;
- Health care and other welfare related assets; and
- Environmental and climate change-related technologies.

Investments in these areas increase the productivity, competitiveness and sustainability of the economy and therefore involve positive externalities. Whether publicly or privately delivered, they currently require renewal and upgrading. The demand for long-term investments applies across the whole economic cycle (such as the industrial innovation cycle), affecting the source and nature of financing at any one time.

The Commission has underlined the needs for significantly higher long-term investment levels in the future, taking into account the lack of investment in the past across a whole range of sectors. Estimates of needs for long-term financing are very significant. For example, overall investment needs for transport, energy and telecom infrastructures networks of EU

importance amount to EUR 1 trillion for the period up to 2020.⁷ Significant investment will also be needed in R&D, new technologies and innovation. Total estimated investment in the EU over the same period is around EUR 24 trillion.⁸

However, in current economic conditions, many enterprises are not able to mount new ambitious projects. The overall demand for more investment is also constrained by macroeconomic and financial uncertainty. For instance in terms of net demand for long-term credit from non-financial companies, recent ECB data reports a decline. The slowdown in economic activity and uncertain market outlook has lowered profitability expectations and the quality of loan applications has deteriorated following the worsening of macroeconomic conditions.

Questions:

Do you agree on the description of the investment needs now and in the future and can you further specify these estimates?

In your view, what is the impact of the protracted uncertainty caused by the financial and economic crisis on the financing of these long-term investment needs?

4. SUPPLY OF LONG-TERM FINANCING

The capacity of the economy to finance long-term investment depends on its capability to generate savings (from households, governments and corporates), to generate credit, to attract and retain foreign direct investments (FDI) for the long-term, as well as its ability to effectively and efficiently channel these funds to the right users and investments.

In Europe, both investment and saving ratios (i.e. the ratio of investment or savings to GDP) remain similar, at 20%. At an aggregate level, this suggests that there are sufficient funds to meet investors' needs. This is favourable compared to other regions: for example, in the US there is excess demand; and, in Japan there is excess saving over the desired level of investment. However, aggregate volumes hide significant differences between Member States, and discrepancies in the sector composition and maturity profile (long- vs. short-term) of both savings and investments. Moreover, the outlook should not be viewed only in static terms, a forward looking and prospective approach is needed.

In terms of savings, households remain the dominant domestic source of funds to finance investment, accounting for 80% of the total, followed by governments and corporate internal funds. While household saving rates in Europe have declined, corporate savings in many Member States have increased and their cash hoarding has grown during the crisis. Studies show that in our ageing societies, households' appetite for risk will diminish, while emerging economies will use more capital to develop the social dimension of their growth models. This could bring an "equity gap". Combined with the fact that US markets are more flexible, the consequences for Europe could be worse.

⁷ About EUR 500 billion in transport, EUR 200 billion in energy and EUR 270 billion for fast broadband infrastructures.

⁸ The total need was estimated for the EU27, using 2011 GDP data at current prices, constant investment rate at 19.8% and assuming the GDP deflator of 1.6 and an average increase of real GDP of 1% until 2020.

Long-term saving and credit should help match resources with long-term investment needs, reducing maturity transformation and related intermediation costs. However, problems in this matching process have emerged. The composition of households' total financial stocks shows that short-term savings (i.e. deposits) are the most preferred instrument by far, followed by shares and other equity⁹ and longer-term savings (such as life insurance policies). With the crisis, decreasing household incomes, increased uncertainties and the low interest rate environment have reinforced the preference of households for stability, liquidity and easy redemption. At the same time, many banks are deleveraging and enterprises are finding it more difficult to finance investment for their development. Alongside cyclical factors, poor performance of financial intermediaries to deliver reasonable returns, together with other structural factors, such as risk aversion of household in long-term decisions and tax (dis)incentives, have all reduced incentives for long-term savings. The spread between the expected economic return and the weighted cost of capital is considered negative, and so it is increasingly difficult to find funding in Europe for investments with maturities of more than ten years.

FDI remains another traditionally-important source of funding, which, despite the crisis peaked in the EU in 2011, reaching a stock of EUR 224 billion, around 30% above 2010 levels.

Questions:

Do you agree with the concerns set out above regarding the supply of savings and financing?

Do current attitudes to risk reduce the incentives for long-term saving and financing?

What are your expectations as regards FDI and how can Europe be made a more attractive destination for inward investment?

5. FINANCIAL INTERMEDIATION: CHANNELLING CREDITS AND FUNDS TO LONG-TERM INVESTMENTS

Among the key challenges of long-term financing, matching present and potential investment needs with financing means is central. This raises numerous questions regarding the structure and efficiency of financial institutions, including the quality of signals given by the pricing system. The negative impact of the on-going credit scarcity and costs of long-term investment must be alleviated, while market-based intermediation should be encouraged and the role of institutional investors upgraded. Before the outbreak of the crisis, economists observed imbalances between savings and investments; inadequacies of savings instruments; short termism in the selection of investments; and, excessive profitability requirements. The situation has since changed: "stability" has become a societal choice, instead of being just a macroeconomic concern, and risk-aversion is now widespread. Thus, even though liquidity and savings are abundant, a number of enterprises continue to experience difficulties in their operations and development, even though most of them need to be supported in the restructuring and innovative processes needed to take advantage of new technologies.

⁹ This high proportion results from the fact that the figure includes also equity investment in family companies. Deducting these equities, EU households retain relatively small portions of shares for the purpose of saving.

5.1 The role of banks

Banks, with their activities in corporate lending, have traditionally been the most important financial intermediaries in Europe. The share of the banking sector in the EU is large by international comparison, reflecting Europe's greater dependency on bank intermediation. Markets activities are much more limited in Europe than they are, say, in the USA. For example, bank loans and other advances accounted for 85% of total non-financial corporate debt outstanding in 2011, compared to 53% in the US. At the same time loans to non-financial corporates and households count for around only 28% of total bank assets.¹⁰

In the years prior to the crisis, European banks relied heavily on wholesale markets and on significant maturity transformation to fund their long-term lending. Further, their significant investments within the euro area and the EU, in particular in sovereign bond markets, which took place during the years immediately following the introduction of the euro, when interest rates converged, left the banks exposed once spreads started to widen.

As confidence vanished, the interbank-market and the flow of wholesale bank funding dried up, highlighting the risks associated with traditional maturity transformation. This has led to necessary deleveraging by banks. This affects many enterprises, but especially SMEs, since they rely mostly on bank lending to finance their investments. Deleveraging is also driven by the weakening demand in some countries in recession. This might have a continued impact on the availability of credit and its costs. Lack of confidence, combined with low interest rates, may also incentivise forbearance, which may in turn further affect bank solvency and thus new lending.

Stress in bank funding, the nexus between banks and sovereigns, short-term risk management considerations and tighter regulation amplify the 'home bias' and may lead to concerted reductions in cross-border financing and divergences between private-sector borrowing costs across countries. This fragmentation of the Single Market undermines the resilience of banks and financial systems; reduces the availability of funding and drives up the cost of capital; constrains the ability of banks to manage liquidity and funding risks; and, ultimately reduces the availability of long-term finance for the economy.

While banks will continue to be important players in the intermediation chain, including by having detailed knowledge and relationships with enterprises, their role and the structure of the sector in Europe is clearly changing. This reinforces the need for other financial institutions and for market-based intermediation to complement the role of banks and contribute to filling the current funding gap.

5.2. The role of institutional investors

Given their business models, institutional investors – such as insurance companies, mutual funds, endowments and pension funds – represent suitable providers of long-term financing in the financial system – assets under management from insurance undertakings, pension funds and mutual funds were estimated in the EU at around EUR 14 trillion in 2011.

While banks are being more prudent as regards longer-term financing and are tending not to go further than the first stages of investment cycles, there is an opportunity for insurance

¹⁰ This represents a serious structural bias, as highlighted in the recent report by the High-level Expert Group on reforming the structure of the EU banking sector. See http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf

undertakings and pension funds to complement the financing landscape and refinance the further stages by providing additional and alternative sources of funds.

The long duration of their liabilities in many cases allows institutional investors, at least in principle, to take advantage of long-term risk and illiquidity premia. They should also be able to behave in a patient, counter-cyclical manner, making the most of low valuations to seek attractive investment opportunities and restraining “short-termism”. The need for diversification and the search for yield given the low interest rate environment have driven their expansion into alternative investments in recent years, including certain types of long-term finance. Other institutional investors – such as private equity, sovereign wealth funds, and dedicated infrastructure funds – have also emerged as providers of long-term capital.

However, despite the potential for these investors to finance more long-term investment and their search for diversification, a number of factors may be influencing their investment behaviour, including lack of specialist project appraisal and analytical expertise, losses experienced in the current and previous financial crises and high volatility in financial markets.

5.3. Market-based intermediation

The efficiency and resilience of markets play an important role in facilitating the flow of capital to growth, especially given current constraints in bank lending.

European corporate bond markets have developed remarkably quickly. Nevertheless, non-financial corporate bonds account still for only 15% of non-financial corporate debt (compared to 47% in the US).¹¹ In practice only large corporates have an access to European bond markets and institutional investors tend to invest in corporate bond funds and other collective investment vehicles, rather than individual corporate bonds. In contrast, mid-caps and SMEs are barely able to tap the bond markets, due largely to the historical lack of credible information about them. Grouping of subscriptions can help. But due consideration should be made to the fact that for SMEs, bank credit and market supply are not equivalent: market debt cannot easily be renegotiated, and cost is higher.

European equity markets also face severe headwinds. Market volatility since 2008 has been high, affecting investors' risk taking ability on the long-term. Market windows for IPOs have also become smaller than ever, including because prices are low. European stock exchanges increasingly play a role as providers of liquidity, rather than a source of fresh capital.

The effectiveness of long-term financing relies also on **corporate governance arrangements** that ensure sufficient engagement by investors. There are a number of factors that may preclude this, creating a more short-term outlook:

- **A lack of engagement by long-term investors** can reduce the focus of companies on longer-term strategies;
- **Shareholder value** prioritises the maximisation of share value over the longer-term fundamental value of the firm; and

¹¹ See Lewellyn J., Dharmasena B. (2012): “Financing European Growth”.

- **The nature of the relationship between investors and asset managers** and the way asset managers' incentives are structured is argued by some¹² to contribute to increasing short-termism and mispricing.

Questions:

What role should banks play in long-term financing?

What role can institutional investors play in the changing landscape of long-term financing?

Do you share this analysis of the current constraints to long-term financing in market-based intermediation? What should change in the way market-based intermediation operates to ensure that the financing can better flow to long-term investments?

Do you agree that this combination of factors contributes to shortening the time horizon for corporate and investment strategies?

6. ENHANCING THE LONG-TERM FINANCING OF THE EUROPEAN ECONOMY

Key to enhancing long-term financing is trust by savers and investors in a growing European economy, supported by effective financial intermediaries aligned to the same long-term incentives. Both public authorities and market participants share responsibility for creating this environment, re-embedding confidence and political and legal certainty, and enhancing Europe's overall attractiveness as an investment destination.

The EU is pursuing a comprehensive programme of fiscal, financial and economic reform. In particular, actions by the ECB to address the risk of re-denomination of the single currency, together with the Commission's proposals to set up a Banking Union, aim clearly at significantly reducing the tail risk linked to a break-up of the euro, which was holding back investors, especially in terms of taking on long-term commitments.

Building on this, and taking into account the analysis in the previous chapters, **action to enhance the long-term financing of the European economy should address a broad range of interconnected factors:**

- **The capacity of financial institutions to channel long-term finance;**
- **The efficiency and effectiveness of financial markets;**
- **The role of public policies in catalysing long-term saving and financing; and**
- **The ease of SMEs to access finance.**

¹² For example, see the 'Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report', July 2012.

6.1 The capacity of financial institutions to channel long-term finance

Banks

As the role of banks in financing the European economy changes, there are two key factors that will affect their ability going forward to channel long-term financing – prudential rules and banking structure. Both are important for ensuring a smooth transition to a new system:

- **Prudential rules for banks** aim at increasing their resilience to risk and instilling confidence. The experience of the crisis showed that it is necessary to prevent excessive leverage and maturity transformation with severe asset-liability mismatches and complex intermediation chains – this has informed to a large extent the approach taken in recent efforts to strengthen prudential requirements for banks. From a long-term financing perspective, prudential regulation must strike a balance between financial stability and the risks faced by banks given the higher default chances of long- versus shorter-term loans, and the potential mismatches that may arise from maturity transformation. It does not follow per se that rules that limit maturity mismatch necessarily translate into reduced lending for the real economy. In principle, it is possible to achieve bank balance sheet resilience without negative impacts on bank lending – for example, through reductions in short-term intra-financial system exposures, by cutting lengthy intermediation chains,¹³ and by attracting more stable and long-term savings. In any case, the potential trade-off between restricting liquidity creation to ensure stability and providing long-term financing for the real economy explains the need for appropriate calibration and progressive implementation of the rules. New proposals from the Basel Committee for liquidity requirements aim at increasing banks' resilience, while ensuring that restrictions on maturity transformation do not have unintended consequences. The Commission has proposed a monitoring period, as well as a review of the calibration of the parameters for liquidity requirements;¹⁴
- The recent report of the High-level Expert Group on reforming **the structure of the EU banking sector** documents how bank behaviour in recent decades has led to a disproportional increase in intra-financial business. The Group recommended restricting and separating out risky trading practices. Discussions are now focusing on the best way to enhance financial stability, promote growth and help to reallocate capital back to customer-facing activities, including long-term financing for companies, including long-term financing for companies. Structural reform may also significantly reduce investors' concerns that the complexity of many large banks make individual investments within their portfolios too complex to price.

Institutional investors

Changes in the banking sector reinforce the need for institutional investors to channel long-term financing, while avoiding any overly-adverse effects of a relative decline in bank financing. As for banks, institutional investors are obliged to meet a variety of prudential regulations and to comply with accounting standards.

¹⁴ See http://ec.europa.eu/internal_market/bank/regcapital/new_proposals_en.htm

The new prudential rules for **insurance undertakings** (the Solvency II Directive)¹⁵ require them to hold assets to cover the nature and duration of their liabilities; holding long-term investments is aligned with the social functions of these undertakings. Solvency II aims at introducing a harmonised economic risk-based regime. The new rules give more leeway by removing the ability of national authorities to introduce quantitative limits and eligibility criteria for investments. The impact of new prudential rules on insurers' long-term financing ability will depend in part on their individual starting point and, as with the requirements for banks, on the exact fine-tuning of how longer-term assets are treated. Discussion has focused on how to ensure that regulatory asset risk capital charges do not weigh overly on the holding of long-term assets such as equity-like instruments, real estate, structured products, and long term corporate bonds. In this context, the Commission services have asked the European Insurance and Occupational Pensions Authority (EIOPA) to examine whether the detailed calibration of capital requirements for investments in certain assets under the Solvency II regime (including infrastructure financing and project bonds; SME financing; debt securitisation etc.) should be adjusted to ensure there are no obstacles to long-term financing, albeit without creating additional prudential risks. The Commission, Council and Parliament have also discussed measures to facilitate the provision of insurance products with long-term guarantees and long-term investments under Solvency II. EIOPA will assess these measures by June 2013, which will inform agreement on appropriate measures for inclusion in the Directive.

Solvency II values assets at **market-consistent economic value**. This approach can enhance the transparency and consistency of financial information for all types of investors as part of an overall appraisal. But it may also be detrimental to stability and long-term financing horizon. For example, some research highlights a reduction by insurance companies and sponsors of pension funds in equity allocations in investment portfolios, since equity is considered more volatile and risky than bonds. Other research argues that market-consistent valuation may encourage long-term investors to increase their risk exposure, if the volatility is recognised outside their profit and loss accounts. Moreover, the combination with current IFRS accounting rules may contribute to spreading market volatility and widening credit/illiquidity spreads on institutional investors' own funds and solvency positions. The impact of volatility may also reduce the positive incentives of the Solvency II framework on rewarding long-term liabilities duration-matching through long-term investments. There is a need for further debate and research about the scope and relevance of market-consistent value accounting in relation to long-term financing.

The trade-off for **pension funds** is around the need to specify a maximum level of risk that pension funds can afford to bear, in order to generate the required level of annual return. Pension funds capital rules differ across Member States. These often differ from those for insurers and take into account the different risks associated with occupational pension liabilities and the funding sources they may access. The Commission plans to review the Institutions for Occupational Retirement Provision (IORPs) Directive.¹⁶ The aims of the review are to strengthen the protection of scheme members, to facilitate cross-border activity in this field and to ensure a level playing field between IORPs and insurers, in light of Solvency II. It will be important to ensure that any new prudential rules for occupational pension schemes do not discourage long-term financing. The review of the IORPS Directive

¹⁵ See http://ec.europa.eu/internal_market/insurance/solvency/future/index_en.htm

¹⁶ See http://ec.europa.eu/internal_market/pensions/directive/index_en.htm

will therefore need to take into account the potential impacts on long-term financing and economic growth.

Beyond prudential rules, a wider range of factors is also likely to affect the behaviour of institutional investors, including **levels of expertise, economies of scale, risk appetite, the availability of appropriate investment instruments and the impact of accounting principles**:

- **Economies of scale and risk appetite:** to address concerns by institutional investors around a lack of risk diversification and the large scale of long-term investment projects, there may be scope to consider initiatives designed to pool financial resources.¹⁷ Similarly, structured financing packages could also help, whereby two investors commit funds to cover both the greenfield and brownfield phases of a project. In this case, institutional investors' money would be used to re-finance the project after the construction phase of the project is complete;
- **Availability of appropriate investment instruments:** The Commission has already committed¹⁸ to make proposals on possible forms of long-term investment funds (LTIF). Pension funds and insurance companies need to meet long-term liabilities and therefore have an incentive to invest in assets that offer a stable long-term yield. Early indications from stakeholders suggest that a new LTIF vehicle could facilitate the raising of capital across the Union. It might help large and mid-range institutional investors to invest, for example, in a range of infrastructure projects. The LTIF will help institutional investors with diversification and risk spreading. In addition, LTIF managers may bring additional expertise in how to look at the underlying transactions, or in how to select and manage long-term infrastructure projects; and
- **Investor expertise:** The asset management functions of non-bank institutional investors are not accustomed to dealing with the more illiquid assets. This means that some investors may need to extend their existing skills to support their investment decisions. The Commission is trying to address this through creating and supporting existing platforms for dialogue between investors and non-financial corporates, as well as through the dissemination of good practices and case studies.¹⁹

Accounting principles

Accounting is not neutral, it shapes economics: accounting standards and measures help provide a common language between entrepreneurs, investors and public authorities, supporting confidence and safety: a true public good. This means they have to reconcile different points of view:

- **An economic interest:** national growth policies have to value the stocks and flows of the economic system; and

¹⁷ Existing examples include the proposed Pension Infrastructure Platform in the UK and the ideas for a common private equity and infrastructure fund between some regionally-based pension funds.

¹⁸ See http://ec.europa.eu/internal_market/smact/index_en.htm

¹⁹ For example, a finance roundtable is being established to identify opportunities to develop adapted finance and innovative financial instruments for supporting resource-efficiency actions

- **A financial interest:** investors (shareholders) need access to standardised, transparent and reliable financial information in order to make informed decisions regarding their investments. Investors use a series of criteria enabling them to measure the financial value of an asset. A common international ground for financial reporting can be beneficial to long-term financing, as it paves the way for a comprehensive and reliable source of information for investors and public authorities. In this respect, the IFRS are a positive step forward.

Fair value accounting principles can enhance the transparency and consistency of the financial information since in principle, fair value shows the market value of assets and liabilities and provides information on the relative financial condition of different institutions. Nevertheless, there is merit in examining further whether these standards are sufficiently connected with policies and entrepreneurs' search for economic efficiency, and whether they properly embody "fair value", in particular when it comes to long-term investment. The economic value of an industrial project or a project involving important externalities is different from its financial value for investors. It seems necessary to shape financial reporting and accounting rules so that they are appropriate for holding and managing very long-term assets.

Questions:

How can prudential objectives and the desire to support long-term financing best be balanced in prudential rules for insurers, reinsurers and pension funds, such as IORPs?

What are the barriers to creating pooled investment vehicles? Could these platforms be developed at the EU level? What are the relevant cross-border considerations?

What other options could be considered to enhance the capacity of banks and institutional investors to channel long-term finance?

To what extent do you consider that the use of fair value accounting principles has led to short-termism in investor behaviour? What alternatives or other ways to compensate for such effects could be suggested?

6.2 The efficiency and effectiveness of financial markets and intermediation

The analysis set out earlier in this document underlines the importance of efficient, resilient and transparent markets in facilitating the flow of capital to growth areas. The challenge from a long-term financing perspective is to ensure that market structures are effective in ensuring non-financial firms can access capital markets and then be matched with the broadest range of investors. This should be complemented by supportive corporate governance arrangements and appropriate information available to investors and other market participants.

Markets

The Commission has proposed reforms to the Markets in Financial Instruments Directive and Regulation (MiFID),²⁰ including to improve market structure through the creation of new trading venues; enhance transparency and information efficiency; enhance requirements to reduce short-term and speculative trading activities; and, improve investor protection.

²⁰ See http://ec.europa.eu/internal_market/securities/isd/mifid_en.htm

The extent to which these reforms succeed in ensuring that equity and bond markets channel long-term financing as effectively as possible to growth and investments will need to be monitored. Further efforts may be needed to develop corporate bond markets in Europe as an alternative to bank lending.

- Reshaping **securitisation markets** is needed. High-quality securitisation can be an important long-term financing instrument available to investors. Securitisation allows an illiquid pool of assets to be converted into liquid tradable financial products to be sold on to investors. Under current market conditions, investors tend to prefer bonds or shares, even though structured credits could help reduce risk. Market-based initiatives to stimulate securitisation markets include emerging labels for high-quality, transparent and standardised securitisations. Unleveraged securitisation vehicles, dedicated markets especially for SMEs and adequate prudential rules and supervision systems are important topics to consider. Further consideration could be given to products linked to specific sectors;
- **Covered bond markets** have proved relatively resilient during the crisis. However, there are significant differences in covered bond regimes between Member States and markets are fragmented along national lines. These differences mean investors need to analyse each country and each covered bond structure separately. Further analysis is required to explore whether and to what extent greater harmonisation, at least with respect to transparency and disclosure, could spur covered bonds as a long-term financing vehicle for the real economy, while taking due account of the concerns that the disproportionate use of covered bonds can raise in terms of increased asset encumbrance of banks' balance sheets; and
- The **European Project Bond Initiative** seeks to demonstrate the feasibility of bond financing for infrastructure projects and ultimately aim to develop a liquid project bond market by enhancing the credit rating of infrastructures investments and enabling a project company to attract additional private capital. The 2012-2013 pilot phase will be followed by an assessment in 2015. Beyond this, there is merit in reflecting on how to promote the use of project bonds further. This could include: a) standardisation and labelling of project bonds issued by project companies in the EU; b) whether a specific regulatory framework is needed; and c) analysing the need and merit for working on the development of a project bonds market (e.g. through a trading platform). Similarly, Project Bonds could be extended to Green Bonds and dedicated industrial Demonstration Project Bonds.

Questions:

How can financial markets and market infrastructure help boosting the long-term financing of the EU economy?

How could the securitisation market in the EU be revived in order to improve maturity transformation by the financial system?

What are the pros and cons of developing a more harmonised framework for covered bonds? What elements could compose this framework?

How could the use of project bonds be developed further?

Corporate governance arrangements

In the area of **asset management**,²¹ work has already been undertaken in the EU to respond to concerns around agency relationships. Detailed rules are in place as regards fiduciary duties, conflicts of interest, remuneration, the exercise of voting rights and cost disclosures. Existing prudential rule for banks and insurers also contain provisions on remuneration. Additional rules have been proposed by the Commission to strengthen the regulatory framework for the provision of investment advice and portfolio management. The proposals should help improve the information to clients as regards the services provided to them and to the execution of their orders.

Further action is also described in the **Action Plan on European company law and corporate governance**,²² which outlines the initiatives that could help promote a clearer focus on long-term financing, such as in particular increasing transparency between companies and institutional investors, improving transparency and shareholder oversight of remuneration policies, and promoting employee share ownership and Social Investment Funds which can contribute to increasing the proportion of long-term oriented investors.

In the longer term, additional steps could also be envisaged, including further assessing the way asset managers' incentives are structured to take better account of long-term considerations and requiring more transparency from asset managers on the fulfilment of their fiduciary duties. Other ideas have also been advanced to encourage greater long-term shareholder engagement, which could be subject to further consideration, such as analysing the possibility of options around granting multiple voting rights to long-term investors and linking dividend payments to the holding period of shares.

Questions:

What more can be done to encourage greater shareholder engagement by long-term investors?

How can the mandates and incentives given to asset managers be developed to support long-term investment strategies and relationships?

Information and reporting

Information and reporting is a key challenge. Stakeholders of companies, in addition to shareholders, should be better informed.

Recent analyses highlight a growing demand for **disclosure of non-financial information by companies**. Research suggests that companies which pro-actively manage sustainability aspects of their operations consistently have a lower cost of capital and tend to outperform their competitors over the long term. Enhanced transparency by companies, including relevant financial and non-financial information, could lead to better investment decision-making, better management and risk-adjusted financial returns. Generic requirements for disclosure

²¹ See http://ec.europa.eu/internal_market/investment/ucits_directive_en.htm and http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm

²² See http://ec.europa.eu/internal_market/company/docs/modern/121212_company-law-corporate-governance-action-plan_en.pdf

might not be enough to stimulate decisions on long-term investments, so the Commission is working on developing a more robust non-financial reporting framework, promoting harmonised approaches and the use of quantified indicators.

Many commentators consider that **quarterly reporting** creates the wrong incentives for investors by imposing an obligation which may push market participants to focus on very short-term results. On the other hand, frequent reporting allows investors and analysts to have constantly fresh views on the situation of a company. In the review of the Transparency Directive,²³ the Commission proposed lifting the obligation for quarterly reporting.

The lack of appropriate **benchmarks** to facilitate long-term decision making has also been cited as a barrier to long-term financing. This may arise from the practical difficulties in producing objective and accurate long-term benchmarks. Existing performance measurement systems tend to be more focused towards short-term results. **Credit ratings** may focus also on annual or short horizons. The way ratings are communicated also diverts attention from long-term perspectives. The Commission has proposed tightening the rules to reduce reliance on traditional ratings and political agreement was reached on several legislative reforms in November 2012.²⁴ The development of metrics and ratings that balance fostering a long-term perspective with short-term accountability could provide a useful tool to assist long-term investors, although this is unlikely to require a legislative basis.

Questions:

To what extent do you think that an increased integration of financial and non-financial information could help stakeholders to get a clearer overview of a company long-term performance, and contribute to better investment decision-making?

6.3 The role of public policies in catalysing long-term saving and financing

The actions of public authorities will have an important role to induce long term investments projects, build incentives and capacity for households to save over the long term and for market participants to channel long-term finance to productive investments. In particular, the role of public investment banks, taxation policy, the use of state aid and public procurement are public tools that can be used.

Public Investment Institutions

The state can catalyse long-term financing by the private sector, either directly or indirectly, offering a range of financing products, including sharing and/or guaranteeing risks, and bringing together financial intermediaries.²⁵ In many Member States, public investment banks exist, are in the making or are planned. They share several features with private banks, such as the need for sound management, but also have specific public policy-related objectives related to social and productive added value. When market failures, such as lower rates of return for long-term investments, prevent investors from taking certain risks and/or making certain investment decisions, public action is needed to help stimulate and crowd-in private

²³ See http://ec.europa.eu/internal_market/securities/docs/transparency/modifying-proposal/20111025-provisional-proposal_en.pdf

²⁴ See http://ec.europa.eu/internal_market/securities/agencies/index_en.htm

²⁵ For example, through the Long-Term Investors Club. See <http://www.ltic.org/>

financing. This can fulfil an important countercyclical role, mitigating any excessive short-termism of private actors and helping to reduce the volatility of funding costs for certain categories of investors, like SMEs. This can be achieved in partnership with banks and institutional investors. A consensus has emerged on these needs.

At EU level, the EIB (which specialises in financing long-term projects), in conjunction with the Commission, can also help limit market fragmentation. With the help of the EU budget, big projects of European interest can be centrally financed and supervised, whereas guaranties can be offered for decentralised projects, linked to European Structural Funds in order to create extra leverage. The impact of foreign sovereign funds, and the opportunity to strengthen or create European ones, could also be considered.

Taxation

The Compact for Growth and Jobs, adopted by the European Council on June 29, 2012, clearly states that tax policy should contribute to fiscal consolidation and sustainable growth. The structure and level of taxation can also have an impact on investment and savings decisions.

[NOTE THAT THIS SECTION NEEDS TO BE SUBSTANTIALLY IMPROVED DURING THE ISC WITH THE NECESSARY INPUT FROM DGs TAXUD AND ECFIN]

This section should cover at least the following issues:

- ***Corporate taxation*** - *Taxation has a significant effect on the supply of long-term financing by corporates; it can offer positive incentives or on the contrary generate more negative distortions. In particular, although equity assets are well-suited to long-term financing, current corporate tax systems in Europe tend to favour debt over equity, creating incentives for higher leverage for firms. A well-designed tax base that reduces the leverage distortion would also make companies less vulnerable to a short-term reduction in credit. Despite the advantages of financing neutrality, reforms that might eliminate this distortion can be found only in very few Member States. Further discussions on the design of corporate tax bases with respect to their financing neutrality could therefore be useful across the EU;*
- ***Tax incentives*** - *there should be a reference to how tax incentives can be used to target behaviour and investment, for example, for tackling climate change. Taxation should address the externalities associated with the use of natural capital: for instance the institution of a sufficiently high carbon tax would be taken into account by investors when calculating the value added of investment projects. Control models exist that incorporate emission reduction constraints and simulate trajectories to determine carbon's social value; and*
- ***The Financial Transaction Tax (FTT)*** *proposed by the Commission in 2011,²⁶ and now to be implemented in several Member States, could indirectly support long-term financing by penalising undesirable and speculative short-term financial market transactions and instead incentivising longer-term horizons.*

²⁶ See http://ec.europa.eu/taxation_customs/taxation/other_taxes/financial_sector/index_en.htm

Questions:

What can be done in terms of corporate tax incentives to stimulate long-term investments?

- **The ability and incentives of households to save over the long term** [FOR DG TAXUD TO INSERT: Household taxation / Taxation of savings – there should be a reference to the role played by the taxation of property and of savings in terms of how this can encourage or create incentives/disincentives for long-term financing];
- **Specific savings accounts could be developed to support long-term financing, including potentially at the EU level.** Several Member States have already introduced savings accounts²⁷ providing a (government) guaranteed fixed return and with certain tax concessions. The funds in these accounts are then invested in public goods such as hospitals, social housing and universities. This model would need adapting to be applicable at the EU level, limiting it to public goods where the EU level brings value added (education, research), or directing it towards projects of general EU interest that may generate a return. It could potentially be offered by banks across the EU. In order to enhance the attractiveness of the measure, the EU budget (or the EIB) could provide an additional guarantee, while Member States could provide certain harmonised tax incentives;
- **Provide the right incentives for private saving.** Auto-enrolment retirement schemes, as already adopted by some EU Member States, represent an additional option for increasing long-term savings rates. The feasibility and impact of such schemes depend on their design and complementarity with existing pension schemes. More generally, taxation also has an important influence on the long-term saving behaviour of households. In the face of wide demographic changes, a priority would be to help young people access adequate training, jobs, and housing, while older citizens will face more financial needs for retirement and dependency; and
- Retail investors may benefit from **tailored financial education** to raise understanding around long-term saving and investment needs. Improving transparency, including on whether the investment propositions are related to long-term assets or not, can also help. Measures were proposed by the Commission in July 2012 to standardise key information documents for consumers.²⁸

Questions:

What can be done in terms of tax incentives to stimulate long-term saving and investment?

What are the merits of developing a model for a specific savings account applicable at the EU level? How could it be designed?

What considerations should be taken into account for setting the right incentives at national level for long-term saving? In particular, how should tax incentives be used to encourage long-term saving in a balanced way?

²⁷ For example, to the *Livret A* in France, or to the *libretti postali* in Italy.

²⁸ See http://ec.europa.eu/internal_market/finservices-retail/investment_products_en.htm

Public frameworks and instruments

Beyond the role of institutions and taxation, a number of frameworks and instruments are available to public authorities that can be particularly influential in shaping the demand for and supply of long-term financing of the economy. It is important that state intervention in this context does not distort competition, crowd out private investors or destroy the level playing field in the Single Market; profitability, even though moderate for public investment, and efficiency of incentives should also be assumed. It is also important to develop clear accountability and assessment frameworks for such interventions:

- **Long-term policy frameworks** set by public authorities support the development of long-term strategic investment agendas beyond the political cycle, providing greater transparency and increased certainty for investors and corporates. In 2011 the Commission proposed an infrastructure package, composed of a new budgetary instrument, the Connecting Europe Facility, as well as revised guidelines for transport, energy and ICT.²⁹ The EIB has developed two risk-sharing finance facilities, including the RSFF for R&D programmes and the LGTT for transport projects. In October 2012, the Commission also adopted a Communication on industrial policy,³⁰ which set out insights on key priorities and questions how to finance them;
- **State Aid rules** provide frameworks for public support to make investments more attractive for private investors. Examples include aid to infrastructure; support to R&D and innovation; regional development; efforts to stimulate low-carbon energy or broadband investments; and, measures to stimulate risk capital³¹ and loan finance;
- **Public procurement** sets the demand from the state (and local actors) for products, services and infrastructure. It may help public authorities to give incentives for innovation and attract investors into long-term projects. However, existing legal uncertainty arising from the absence of clear rules on the award of concession contracts creates constraints. Therefore, in December 2011, the Commission proposed a directive³² with the aim of providing a clear and simple framework for the award of such contracts;
- **'Bridging products'** are additional instruments to ease investors' risk aversion. Examples include first-loss credit or mezzanine credit enhancement;³³ vehicles specializing in early-stage and large-scale demonstration projects;³⁴ and public-private partnerships. The Horizon 2020 framework includes debt and equity facilities to provide risk finance to innovative European SMEs. In many countries market finance for public-private partnerships (PPPs) involving risk sharing has shrunk. The revival of this type of market,

²⁹ See <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0676:FIN:EN:PDF>

³⁰ See <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0582:FIN:EN:PDF>

³¹ See http://ec.europa.eu/competition/state_aid/legislation/horizontal.html. The Guidelines on State aid to promote risk capital will be revised in 2013, in the context of the State aid modernisation initiative.

³² See http://ec.europa.eu/internal_market/publicprocurement/modernising_rules/reform_proposals_en.htm

³³ In these vehicles, a government offers a minority share of the project funding, placing itself lower in the ranking of creditors in case of loss. This can help increase the rating of the remaining share of funding.

³⁴ In these vehicles the public sector invests alongside private sector and institutional investors or takes subordinated equity positions in funds.

notably for trans-border investments, is important. A European framework for PPPs and public finance initiatives may support their use and impact;

- **Coordination, assessment and accountability** between national and EU-level action can be made more efficient and prevent conflicts of interest across infrastructure, and R&D projects, as well as new industrial technologies (where sectoral and cross-sectoral incentives are needed). This could undoubtedly enhance the value added of a European approach. Closer cooperation between national public investment institutions, under the aegis of Commission and EIB, could provide a vehicle for such coordination, including by supporting the creation of European economic interest groupings for the financing of cross-border projects; and
- *[TO BE REVIEWED IN PARTICULAR BY DG TRADE]* **Export credit.** Several national public export credit guarantee schemes exist in Europe today, which provide support to capital-intensive investments requiring long-term finance. It could therefore be useful to analyse whether an EU Export Credit Mechanism could help the financing of long-term investment, in particular outside the EU and in non-euro denominated projects, in complement to those national approaches.

Questions:

How could the role of public investment institutions be enhanced?

How can state aid and public procurement better frame the provision of long-term financing through credit enhancement measures and/or equity instruments providing upside/downside risk-sharing ?

What is the role of sovereign wealth funds in long-term financing in Europe?

Is there a need for a European public-private partnerships framework?

How could an EU Export Credit Mechanism help the financing of long-term investment?

Do you agree with these suggestions for coordination, assessment and accountability regarding cross-border projects?

6.4 The ease of SMEs to access finance

The small and medium-sized companies (SMEs) of today have the potential to underpin the long-term growth of the future. They have historically faced significant difficulties in accessing funding to grow. The constraints on bank lending discussed earlier may impact disproportionately on SMEs.

To address these problems, in 2011, the Commission adopted an action plan,³⁵ many of the legislative proposals of which have not yet been adopted by the Council and Parliament. [The Commission's proposals for the revamp of bank capital requirements include specific provisions to support safe lending to SMEs – *TO BE REVIEWED IN LIGHT OF LATEST DEVELOPMENTS ON THE CRD IV*]. Proposals are also on the table to provide an EU

³⁵ See http://ec.europa.eu/enterprise/policies/finance/files/com-2011-870_en.pdf

framework for the investment in venture capital and in social entrepreneurship funds.³⁶ [In 2012 the Commission also completed its examination of possible tax obstacles to cross-border venture capital investment and is now considering next steps – *DG TAXUD TO PROVIDE UPDATE ON LATEST DEVELOPMENTS IN THIS AREA*]. Proposals have also been presented to allow the operators of multilateral trading platforms to be registered also under the label of "SME growth market"; and, for a proportionate regime that will decrease administration costs and burdens for SME's accessing markets for funding.³⁷

But these measures may not be sufficient to address the difficulties of SMEs to access credit and capital markets. Further steps could be considered, including:

- **Developing venture capital.** This is the main source of capital for fast-growing SMEs, injecting seven times more equity investment in these businesses compared to equity investment from stock exchanges into to mid-caps. This sector suffers from lack of resources and is influenced by bank and insurance regulation. A fund of mutual guarantees for institutional investors could reduce these constraints;
- **Developing new securitisation instruments for SMEs.** At national level, specialized institutions provide credit and guarantees are offered by public authorities. At European level, the European Investment Fund manages a loan guarantee finance facility (LGTT) and a mechanism for risk-sharing. This is linked to the Commission's securitisation instrument under Competitiveness and Innovation Programme (COSME) to promote access to finance by SMEs. These instruments could be further enhanced. Under EU criteria for SMEs' industrial investments of European interest, vehicles for structured credits could receive European labels. Banks would originate credit and keep part of the risk; institutional investors would provide liquidity; and public guarantees possibly provided. In view of the wide differences between industrial sectors and between investment cycles, this device should be differentiated;
- **Developing dedicated markets for SMEs.** This could include creating a distinct approach for SMEs, going further than the SME label in MiFID, and linking up more effectively with other regulations, for instance concerning investors. This could include the development of specific accounting rules for listed SMEs (such as IFRS for SMEs). In addition, SME bond markets could also help attract new investors (both institutional and retail) and support the developments of any new SME securitisation instruments;
- **Developing credible and minimum standards in assessments of SMEs for non-bank investors through credit scoring.** This could help address the current lack of credible information about SMEs and the related difficulty for potential investors in evaluating their credit worthiness. This would be especially useful for enterprises seeking increasingly to access capital markets, where the demand for external credit worthiness evaluation, rating equivalencies and credit standing certificates has developed significantly. Developing harmonised minimum quality standards on external evaluation of mid-caps and SMEs could further facilitate their access to finance, including across borders, and deepen market integration; and

³⁶ See http://ec.europa.eu/internal_market/investment/venture_capital_en.htm

³⁷ See http://ec.europa.eu/internal_market/securities/prospectus/index_en.htm