7TH ANNUAL CONFERENCE OF THE LONG-TERM INVESTORS CLUB

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HOW TO TAKE ON THE LONG-TERM CHALLENGE

Opening Speech

by Franco Bassanini

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Ladies and Gentlemen,

I am honored to open the 7th Annual Conference of the Long-Term Investors Club.

The Club was founded in 2009. At the time – in the midst of the crisis - the crucial role of long term investment for growth, competitiveness and social cohesion was not at the center of the debate.

Today, long-term investment is one of the guiding principle of the EU economic and investment policy. Since 2013, with the G 20 of Saint Petersburg, Brisbane and Ankara, it is in the agenda of the global institutions.

Among academics, experts, opinion leaders, policy makers, and the business community the belief that long-term investment is crucial for the future of the world economy is now widely widespread. At the same time, it begins to spread the awareness that, if it is true that financial stability is a condition for growth, it is also true that there cannot be financial stability without a balanced, stable and sustainable growth.

So we have gone a long way and we are proud of it.

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After five years of continued slowing down, global output is still stagnant. We are diverging at a higher speed than we thought just a few months ago. Mild recovery characterized most advanced economies – slow down characterize, in general, developing and emerging economies. This creates tensions in the flows of money and goods.

After the Renminbi crisis last August, financial market volatility is back and a synchronized global economy remains elusive.

The world economy however is ever more integrated and this plays in favor of long term stability in the interest of all participants. We lack levels and pulleys to govern the global system – so often unexpected shocks are beyond our capacity to predict and to avoid them.

Large regional wars or economic imbalances produce sudden flows of people, creating economic, political and social shocks.

Demographics differs by regions. Europe is old. This will weigh on its long term future. US are younger and younger are most of the developing and emerging economies.

The US have a strong financial system with a large and dynamic capital market, have invested over 1.5 trillion dollars in network, urban and social infrastructure, R&D, support to internal demand. Moreover they can count on major technology transfers from their large defense industry. Finally, the cost of US welfare is about half of the one in the EU.

Europe is fiscally responsible, it is still one of the largest economic area in the world, has a potentially large and stable banking system, which is however still suffering due to low profits. European banks are safer that they used to be, but they are worse in their traditional banking function to distribute capital from saver to business. Moreover, much regulatory uncertainty is still surrounding the European banking system. Fortunately, generous EU welfare maintains social cohesion and internal demand, but its cost threatens the balance of public finances over time.

The plurality of states makes Europe politically weaker. Institutional building after the crisis has speed up, but it is still slow in comparison with the unfolding of financial and economic events. Fiscal consolidation, financial distress and regulatory uncertainties had negative effects on investments. In Europe, private and public investment decrease exceeded €550 billion between 2007 and 2014.

China maintained very rapid growth rates during the past decade. With the rise of commodity prices, Chinese exporters started investing heavily in capacity, fueling domestic growth. Now China has targeted lower rates of growth, seeking to re-balance its formerly export and investment driven economy in favor of consumption, including services. This means lower growth not only for China but also for their neighboring countries and more generally for the entire world economy.

The last IMF World Economic Outlook released in October 2015 has revised the growth rates downward: about one third of the growth reduction in world economy are due - according to the Outlook - to reduced levels of investments, mostly in technology, innovation, R&D, and infrastructures.

Demographics, Energy, Infrastructures, Environment and Technology are the fifth major challenges. They all need investments and long term support.

Let me make now three points on long term investments. One on regulation; one on infrastructure financing; and one on Europe.

The prudential and accounting regulatory framework.

Basel III and IAS/IFRS had negative effects on long-term investment. They reduced banks capacity to lend to infrastructure and corporates (especially SMEs) and institutional investors capacity to buy long term investment asset. When Basel III was first introduced, in aftermath of the financial turmoil, it was designed to ensure stability and proper risk assessment, to speed up banks' balance sheet repairs and to favor a return to sustainable leverage. Important results have been achieved in terms of crisis prevention and supporting financial stability. But the new accounting rules and the new capital and liquidity requirements penalized the financing of investment, especially in the bank based European financial system, and consequently contributed to deepen and prolong recession and stagnation: at the end of the day, economic recession always undermines financial stability.

Underestimating these consequences, the international regulators are now planning further stiffening of accounting requirements and prudential rules. The Basel Committee is debating a new set of rules, which would make it even harder (in terms of capital absorption and liquidity ratios) to finance infrastructures and the real economy. A recent Report by the Financial Stability Board (March, 2015) is suggesting to revise the zero weighted treatment of sovereign and government-related exposures under the capital and liquidity requirements of banks (the Basel III agreement and CRR/CRD IV), including the large exposures regime, as well as the zero weighted treatment of sovereign and government-related exposures under the solvency rules of insurance companies (Solvency II).

But on the contrary, and at the same time, policy makers, academics and the business community are increasingly becoming supporters of the need of re-calibrations toward a regulatory framework more investment friendly. The question is at the center of the G20 global agenda since 2013 (Saint Petersburg). World Bank, IFC, OECD, and FSB have been given by the G20 the task to look deeper into the question. So, something is moving also at the global level.

A first general question regards the "mark-to market" philosophy and its unintended negative effects on specific classes of long term assets that – for their very nature - can go over the cycle and are kept on the books – by some classes of investors - for a long time. Business model of intermediaries should be taken into account, especially if made up of long-term assets and liabilities. The standards should promote anti-cyclical behaviour and long-term investment compared to short-term financial investment.

The hope is provide solutions which do not penalise more those institutions which have a business model based on long-term assets and liabilities (such as pension funds, insurance companies and SWFs) or which operate on a long-term and with a 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 their portfolios for a long period of time. Thus, this would prevent the main indicator for measuring the profitability of an asset from being distorted by short-term fluctuations. We know of course that such an address, albeit logical, would find technical and ideological barriers difficult to overcome.

Both Basel III and IAS/IFRS have had different effects on different financial systems – bank-based systems were more penalized than market-based systems. Moreover, they have also not been applied universally and this created uneven conditions between and among regions and countries across the world. The strongly bank-based European financial system, for instance, pays a greater price due to standards unfriendly to long term investment than that paid by market-based financial system (USA) and by Government based financial systems (China).

We should not forget that one of the fields on which global competition is playing its game is the setting of prudential regulations and accounting standards. It has become a major weapon in the global economic and financial war, which characterizes the XXI Century, hitting mostly more some systems rather than others.

We need to avoid "regulatory arbitrage" and support homogenous treatment of long-term investment. It is in the general interest of the whole global economy. International, regional and national regulators should then work together to avoid regulatory asymmetric global environments.

In Europe there is general consensus that the Juncker Plan and the Capital Market Union will not take-off if significant changes in the prudential and accounting standards are not implemented soon. Jacques de Larosiére at the Eurofi Forum in Luxemburg in mid-September 2015 made a bold proposal: to take tough action on CRR and Solvency II by reducing (at least temporarily) the capital absorption for infrastructure and for securitization of SMEs loans. Calling for a sort of "recalibration shock" the French economist and central banker is asking policy makers and regulators to concentrate on two of the sectors which suffer the most in Europe: infrastructure and SMEs.

Recently, on 30th September 2015, the European Commission has proposed – on advice of the European Insurance and Occupational Pensions Authority (EIOPA) – a new legislation in order to modify the Solvency II Delegated Regulation to create better incentives for insurers to invest in infrastructure projects, in particular by reducing the amount of capital which insurers must hold against the debt and equity of qualifying infrastructure projects.

This is very good news for us, since already back in 2011 we stressed the urgent need of specific amendments[1] to the Solvency II Legislation in order to (i) remove actual disincentives for infrastructure investments of institutional investors, (ii) restore consistency between EU Legislation and its final policy objectives, as well as (iii) don't waste economic and financial resources alongside policy efforts.

The current amendments proposed by the EC to the Solvency II Delegated Regulation include:

1. a new concept of "qualifying infrastructure investments"[2] treated – at last – under Solvency II as a distinct asset class (category), which will benefit from an appropriate risk calibration (thus leading to lower capital charges[3]);
2. lower capital charges under Solvency II for investments in European Long-Term Investment Funds (ELTIFs);
3. the same capital charges (39%) for equities traded on multilateral trading facilities (MTFs) as for equities traded on regulated markets;
4. the extension of the benefit of transitional[4] measure to all equities while previously only equities traded on regulated markets were covered.

The Commission announced that also CRR will be modified to make amendments to the regulatory framework of securitizations in EU law, including in the area of capital charges for credit institutions and investment firms originating, sponsoring or investing in these instruments. This is also a good news since securitization is a pillar of the Capital Market Union and may be an instrument to free up capital for new long term lending. The Commission finally also announced to complete the review of the CRR for banks, making changes on infrastructure calibrations if appropriate. The hope is that the re-calibrations will be well done – respectful of proper asset class risk assessments – but strong enough to give a boost to long term finance in Europe.

These very recent actions plans show that in Europe something is finally moving. It is going to be enough? Let's wait and see.

The need to create infrastructure as an asset class and to support SMEs

To increase long-term investors' asset allocations, infrastructure needs to be transformed from the realm of an 'alternative' investment category into a real 'asset class'. This would then attract new streams of investment from around the world. Pension funds, insurance

[1] Please refer to "*Financing Infrastructure in Europe: Project Bonds, Solvency II and the Connecting Europe Facility*" of Franco Bassanini, Gino Del Bufalo and Edoardo Reviglio, September 2011.

[2] These are investments that present better risk characteristics than other infrastructure investments and therefore meet "qualifying criteria" for safer projects that are able to generate predictable cash-flows and withstand stressed conditions.

[3] All infrastructure equity investments will have a risk calibration of 30% of their value, compared to the previous 49% for unlisted equities. Infrastructure investments in the form of bonds or loans will also qualify for lower capital charges. For example a 20-year bond with a credit quality step 3 (on a scale of 0 to 6) will have a risk calibration of 20% instead of the previous 30%.

[4] Solvency II contains a transitional measure that phases out the previous equity capital charges, and phases in the new charges over a period of seven years, for equities purchased before the end of 2015.

companies, asset managers, foundations, endowment funds and sovereign funds seem to have a growing appetite for investments in infrastructure. The new model should be technically very advanced, as well as financially reliable, and standardized in order to attract long term investors and private capital around the globe, where the demand (and the competition) for capital investment will increase, at exceptionally high rates, throughout the XXI Century, and where liquidity is great, but is directed where risk is lower and yield is higher.

The infrastructure sector – however – still faces major challenges.

These include insufficient investments, partly due to fiscal consolidation, as well as shortcomings caused by poor project selection and planning, inefficient delivery and persistent emphasis on building new capacity rather than using existing assets optimally. Among the market inefficiencies, there is a lack of suitable project pipelines, inadequate risk-adjusted returns, prudential and regulatory constraints and high development and transaction costs, lack of public resources to complement cash flows coming directly from the projects, which often are not sufficient to make the economic and financial plans sustainable in the long term.

So governments and public administrations, international regulators and the financial industry have a lot of work to do.Governments need to increase public investment and the ability to attract private capital. Those under fiscal pressure can build on various forms of tax incentives, user fees and divestures. They may capture property values of land.

Governments worldwide should intensify privatization of brownfield assets and utilities to finance new infrastructure developments. They need to increase private and institutional investors' participation in PPP-like structures by establishing comprehensive policies in this sphere, with an appropriate legal and institutional framework. They should increase transparency and provide visibility in project pipelines, establish efficient bidding and procurement processes, and improve risk distribution by providing credit enhancement and/or co-investment mechanisms.

The global financial industry can increase availability of long-term financing through standardized financial documents, agreements and contracts. Also methods to facilitate refinancing or resale of mature investments on the books of institutional investors and development banks are needed.

Establishing infrastructure as a fully-fledged asset class will open up this category to a broader range of investors and pave the way towards innovative financial instruments.

This means capacity to bundling and securitizing equity and debt of investment vehicles with well-defined risk-adjusted returns and customer-focused investment periods.

The industry needs to develop local and regional capital markets and give a boost to capital market instruments (such as project bonds and asset-backed securities for project financing loans). This requires a new complementary relationship between banks, capital markets and institutional investors. The Juncker plan for greater investment in Europe together with the Capital Market Union may have an important role to play here.

Despite this change in public outlay, there is a need for new models that engage private sector investors, that can help them to deal with the current low interest rates environment and provide a predictable (inflation adjusted) cash flow with a low correlation to existing investment returns.

The rationale is that financial markets, the real economy and society form a holistic entity. Each depends on the other two. None of the three is inherently stable. In the interplay of economy, society and financial markets, infrastructure provides a key catalyst for employment, money and interest. This is why we believe that infrastructure is a desirable option for long-term investors and an under-utilized resource for public service and social sector providers.

Finally a few words on SMEs, startups and venture capital.

SME startups and venture capital are another long term sector which is crucial for the economy. They are vital sources of productivity growth, innovation and, therefore, economic growth and job creation. At the global level they employ more than two thirds of the private sector workforce, and provide over 80 percent of net job growth (*B 20 SMEs and Entrepreneurship Taskforce*, 2015).

There is a growing attention not only in the EU but also at the global level to find common solutions and create a more level playing field among SMEs in different regions and countries of the world. The *B 20 SMEs & Entrepreneurship Taskforce* has launched the *World SME Forum* (WSF) announced on May 20, 2015, in Istanbul. The WSF is a global SME platform geared to supporting implementation of the proposed recommendations, and a major initiative to drive the SME sector's contributions to global economic growth and employment.

At the European level there are several initiatives which have been set up in last few years and some new ones which have been recently included in the "Action Plan" of the Capital Market Union (CMU).

They include: support to venture capital and equity financing; tax incentives for venture capital and business angels; information platforms and advisory capacities; promote innovative forms of corporate financing and strengthen access to public markets; explore, with the IASB, the possibility to develop voluntary tailor-made accounting solutions, which could be used for companies admitted to trading on SME Growth Markets Review; support fiscally equity financing, including treatment of debt-equity bias; building a securitization market for SMEs loans and revise the capital calibrations for banks and insurance to make it convenient; and explore the feasibility of covered bonds for SME loans.

Indeed a quite ambitious "Action Plan" which should be implemented with different timings in 2015-2017.

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Ladies and gentlemen,

Let me conclude with some general remarks on long term investments in Europe.

The new framework designed by the Juncker Commission represents a shift in the economic (investment) policy of the EU.

Alongside with the two Communications of the EU Commission on Flexibility and on State Aid Modernization, the general framework has been partially revised. New principles have been introduced.

The first is the principle of fiscal flexibility. The "investment clause", for the first time, contains some timid "flavor" of the "Golden Rule". The contributions of MSs to the Junker Plan's regional or thematic Platforms, under well-defined and tight macroeconomic and fiscal conditions, could be exempted by the Growth and Stability Pact.

The second is the principle of additivity ("filling market failures or sub-optimal investment situations").

The third is the principle of "good aid" – defined as "the decision on State aid on well-defined market failures and on objectives of general interest".

The fourth is the "complementarity to the market" of National Promotional Banks – and the recognition of their institutional role as pillars of the European Fund for Strategic Investment (EFSI) alongside the EIB.

The fifth is the Capital Market Union with its recently released "Action Plan".

Such principles do not shake the foundations of the economic constitution of the Union – they are, however, seeds of potential future transformations. A change is needed both to promote a stronger EU Single Market and to reduce the competitiveness gap of the European economy at the global level. But a change is also needed to increase convergence among MSs. We need a new "smart" policy – more flexible and aimed at reducing divergences that after the crisis have dangerously increased.

Let me explain what I mean here.

One of the founding ideas of the European Union was the ambition of creating a big single market in which open competition between European businesses would produce innovation, efficiency, productivity and thereby growth and employment, as well as "creative destruction". For this to happen, the playing field needs to be leveled, so as to build a virtuous competitive convergence among the European economies. To reach this objective, a strict competition guideline was introduced along with a complex set of laws aimed at ensuring that state aid policies do not create improper competitive advantages for the businesses of one or more country, resulting in a playing field that is no longer level.

This aim remains valid. But it has not been achieved. Indeed, we cannot fail to observe that a business in southern Europe suffers major competitive disadvantages compared to its northern European competitors, in terms of the cost of money, energy and logistics, as well as regulatory, bureaucratic, legal and fiscal costs. The playing field is by no means level, instead, it resembles a German city at the end of the Second World War, after three years of Allied bombing.

To reduce these asymmetries and make the single market effective, it is of course necessary to approve and implement the needed national structural reforms (liberalisation of markets, modernisation of government, reform of the labour market, etc.). But once again, national reforms, while essential, are not enough: the competitive handicaps in the cost of energy and logistics, for example, require major investment in European infrastructure networks and, more generally, effective European energy and infrastructure policies. But the same could be said for fiscal and regulatory harmonization, no less necessary to guarantee fair competition. Even a revision of the rules on State Aid may be considered, in order to allow, under the close supervision of the European authorities, public measures and interventions aimed at reducing competitive handicaps (among and between different European countries and between them and the rest of the world), at the same time strengthening the ban on measures that make the handicaps worse.

On global markets, Europe faces big countries that do not hesitate to use public resources to support investment and industrial policy actions when needed (China, for example, but also the United States, home of the free market). These countries have strongly re-launched strategic investment, not only in infrastructure, but also in innovation, R&D, education, technologies. In this way, they have rapidly recovered to pre-crisis growth rates, while Europe is still in the doldrums. We need to ensure that Europe does not become a Europe of book-keepers, where policy is limited to talking about decimal points, instead of talking of the future of the biggest economic region in the new globalized world, which needs to invest much more in networks, innovation, technologies, and infrastructure, to grow and be competitive.

In this framework, the Juncker Plan must not be considered just as a new large Guarantee Facility for European SMEs and infrastructure. It should instead be considered as an anti-cyclical tool to boost investment and growth, and a first step towards the creation of a Single European Market for Infrastructure and SMEs financing. An opportunity to stimulate national reforms and processes (legislative stability, streamlined and fast administrative procedures, light regulatory burdens, fast and reliable judicial systems, efficient and technically prepared public administration, information platforms, transparency, technical assistance, cutting red tape, etc). Juncker guarantees, if needed to face market failures and if granted with competitive procedures, should be always considered compliant with State Aid rules. The goal is in fact to help in leveling the playing field at the global level, in order to allow European SMEs, PFI and PPP projects to compete in the global market.

Ladies and gentlemen,

Let me conclude

Seven years have passed since we created our Club.

Our role has been important in these past years. As I tried to argue much has been done, but much has still to be done. Our mission is far from achieved, as well as the mission of our institutions as long-term investors and key promoters of growth, competitiveness and social cohesion of our countries.

We need to be able to understand how to adapt to a changing world our culture, our approaches, our instruments and our initiatives. And how to rethink our roles and our relationships with commercial banks and with all other long-term investors.

To collect ideas, suggestions, and visions of the future we have today gathered economists, policy makers and representatives of the financial industry. I am sure that they will be able to tell us what needs to be done .

I wish you a most fruitful two days of workings.

Thank you.