The Juncker Plan

by Edoardo Reviglio

The Juncker Plan represents a change in the economic policy of the EU. Alongside with the two Communications on Flexibility and on State Aid Modernization the general framework has been partially revised. New principles have been introduced. Such principles are not shaking the foundations of the economic constitution of the Union –they are, however, seeds of potential deeper transformations. They introduce, in fact, a "smarter" convergence policy – with a stronger focus on the actual state of divergence among MCs and a lesser obsessive focus on competition and State Aid discipline. But which are – in the essence – these new principles?

The first is the principle of fiscal flexibility – the "investment clause", for the first time, contains some elements which go in the direction of the "Golden Rule". The second is the principle of additivity ("filling market failure 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 EFSI alongside with the EIB.

In this new context, the Juncker Plan takes on broader and deeper significance. It is not simply a new large Guarantee Facility for European SMEs and infrastructure. But it should instead be seen "in nuce" as a first step towards a Single European Market for Infrastructure and SMEs financing – towards an "Infrastructure Union". The Plan represents also an opportunity to promote and stimulate ambitious reforms at national level and the re-visitation and recalibration of the different processes required for carrying out investment projects. Investment in fact requires much more than improved funding. It needs 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).

The European infrastructure (and SMEs) finance market is in a transition from a model dominated by bank financing to one in which many actors play a role, such as institutional investors, infra funds, pension and life insurance platforms, banks, multi-lateral and national development banks, sovereign wealth funds and other private sector investors. The on-going evolution of this increasingly diverse market will require the various stakeholders developing new and innovative financial instruments capable of efficiently allocating available capital to projects. Financial engineering may be essential. The new innovative financial instruments must be compliant with the emerging post crisis regulatory regime, which itself still needs more and brave policy actions and a general fine-tuning recalibration (on capital charges, information platforms, standardization of public procurement schemes, fiscal incentives, corporate governance, legal and regulatory environment, both in terms of land planning and licensing and in terms of sector-specific regulations that shape the cash flows, etc.). This seems to be the direction taken by the recent "Action Plan" (and related documents on re-calibration of CRR/CRDIV and Solvency II, on securitization, etc.) released September 30 by the EU Commission..

The Capital Market Union (CMU) should increase the potential of the European financial system, especially in sectors such as infrastructure and SMEs. Is this true? And if it is true how long it will take to develop capital market instruments for infrastructure and SMEs in the Europe?

In Europe the banking system has traditionally provided finance for growth. What kind of financial instruments could be introduced in European capital market to finance infrastructure and SMEs? To finance infrastructure we could rely on: project bond, securitization (or covered bonds) of project

finance and PPP loans and unlisted equity. To finance SMEs we could also rely on securitization (or covered bond) of loans to SMEs, debt funds and private equity (and venture capital).

The open question is if these instruments will grow at a sizeable amount at least not in the next two or three years, that is the life time horizon of the Juncker Plan.

First, with low interest rates and abundant liquidity European banks have no interest in securitizations, neither as a new source of funding nor to free up capital. Why should they sell “old” investment grade loans with higher interest margin to free up capital to make new loans with much lower margins? European banks need to increase their profitability to transfer retained earnings to capital – to decrease their leverage. So until interest rates do not pick up again there seems to be no convenience for European banks to enter into the ABS market. This includes both ABS SMEs and ABS Infrastructure.

Another capital market instrument for financing infrastructure is Project Bond. Project bond are those issue directly by a project company. The global market for project bond is worth around 170 billion dollars, of which around 90% is issued in China. The US market is worth only 3 billion dollars and the European market - thanks to EIB Project Bond Initiative – around 4 billion euros. There are potential for increase but mostly for larger project – at least for the next few years. So project bonds may participate to the European capital market in the future. However, the large average size of each single project bond makes this market still rather illiquid.

Second, even if the interest rates were higher still to make ABS attractive for banks (as issuers) and institutional investors (as buyers) a proper recalibration of CRR/CRIV and of Solvency 2 needs to be implemented by the EU Commission. The Action Plan for the CMU goes in this direction. We hope that the proposed changes will be “brave” enough to make ABS attractive when the right market conditions will arise.

If we want to move from infrastructure as an “alternative class” to infrastructure as a full-fledged “asset class” we need to develop new capital market financial instruments and this is a challenge which may require more time than expected by the Juncker Plan.