



Draft for discussion

Relaunching Long-term Investment and Financing in Europe

***Position paper of the Italian Banking Insurance and
Finance Federation***

1. From investment-less stagnation to an investment-driven recovery

The EU must go back to sustainable and inclusive growth as quickly as possible: this requires long –term investments and corresponding finance. Between 2007 and 2013 public and private investment declined in real terms by one-fifth in the Euro-area. This has sapped growth and growth potential, reduced international competitiveness, created significant unemployment notably among the young. Not only physical but also human capital has been, and is, adversely affected.

Difficulties in the Euro-area are especially acute in stressed peripheral countries but reflect also weaknesses in the core. The capability of reforms to re-launch economic growth is being undermined: as the Italian Minister of Economy and Finance put it: “the time for action on investment and structural reforms is now”.

Economic recovery, rebalancing of structural misalignments and sustainable growth need to be investment driven. Capital formation leads to innovation and enhances competitiveness, it represents a crucial link between demand, supply and productivity.

Fiscal consolidation should not result in severe cuts to public investment in effective and efficient infrastructure projects, in green energy, TLC, R&D and support measures for SME investment. Large and small good infrastructure projects deliver benefits with important externalities. Public and private partnerships and co-financing schemes must be actively supported; it is however evident that all the advantages of infrastructure outlays cannot be fully captured privately.

Given the intensive employment and demand generation character of the SME sector in Europe, positive externalities also follow from sound SME investments. Without entering here into the debate on existing fiscal rules in Europe (which do not make a distinction between current and capital public expenditure), it is clear that novel avenues should be found to revive capital outlays. This requires putting the long-term financing process on the right track in Europe: a multi-faceted effort in many areas.

2. Innovative financing for investment in Europe

Weak investment has gone hand in hand with a long period of contracting bank credit to the corporate sector. Fixing the banking system and deleveraging were necessary critical steps; the decline in bank lending was due to both demand and supply factors. After the long-awaited AQR and stress tests conducted by the ECB (SSM), banks can again support lending, but the post-crisis financial reforms make it difficult for banks to directly play a key role in long-term finance. New constraints should be absolutely avoided.

The traditional strong dependence of Europe on bank intermediaries to channel savings into long-term investment must evolve into a more diversified financial framework with a greater role provided by capital markets and by institutional (long-term) investors.

To foster these developments and to remove barriers to long-term financing the Commission adopted in March 2013 a Green Paper which was followed by an exhaustive public debate. The Italian Banking Insurance and Finance Federation endorsed the objectives of the Green Paper and actively contributed to the public consultation. A key follow-up was the establishment through a corresponding legislation of the European Long Term Investment Funds (ELTIF). ELTIFs can promote the creation of an important vehicle for investors. Regulatory adaptations are however required to attract institutional investors. The issues of product suitability for the retail sector deserve further careful attention. Fiscal advantages for long-term

holding periods should also be introduced on a consistent EU basis. Detailed proposals on all these points have been made by the Federation.

3. Recent reforms in Italy

The Italian government has recently moved ahead with bold structural reforms in this field in order to diminish bureaucracy and simplify procedures, remove obstacles, facilitate access to credit, and support both public and private investment.

New legislation was enacted in order to create a regulatory and operational environment that is favourable to market financing and private debt, particularly for medium sized enterprises: i.e. the so-called “Mini-bond framework”. Mini bonds are especially tailored to the needs of small to medium sized companies. The Borsa Italiana (part of the London Stock Exchange Group) launched a specific platform to cater for such deals (Extra MOT Pro). As part of the wide-ranging law-decree Decreto sviluppo (2012) legal and tax obstacles to unlisted companies for issuing bonds were lifted.

As examples of credit liberalization measures, insurance companies and securitisation companies (SPV) are now allowed to lend directly to firms. New regulation has also liberalized direct loans from credit funds. Fiscal constraints were removed to provide better access to capital markets. Targeted tax-relief was also introduced to support investment (e.g. 25% tax credit on incremental investment in R&D).

Measures were introduced to reinforce companies capitalization, create incentives for funding on the stock market, through e.g. a more favourable Allowance for Corporate Equity (ACE), and to make it easier and cheaper listing in the stock market.

In the recently enacted “Sblocca Italia” decree, geared towards attracting private capital for new infrastructure and creating the ground for matching financing demand and supply, measures were introduced to make project bonds more appealing, incentives to private investment in broadband and natural resources exploitation, and a new discipline for real estate investment trusts were established.

The Federation has actively contributed to the national debate on the improvement of the capital market and the promotion of long term investment, through a Task Force with representatives from all the sectors of the financial market (insurance, real estate, pension funds, banks, asset management funds, etc.), chaired by Prof. R. Masera. This Group has also promoted a common approach of the whole Italian financial sector to

the European discussion by responding to consultations, such as the one on the European Commission Green Paper on Long-term Financing, and by promoting ideas and proposals.

4. The Juncker Plan: many opportunities and one (serious) constraint

The Juncker Plan was presented to Parliament on 26th November 2014. In its present formulation, which is still general and lacks details, the Plan looks well structured and promising. In fact:

a) The plan is ambitious and comprehensive. It is based on a three pillar approach: a public European Guarantee Fund (the European Fund for Strategic Investment EFSI), a system of advisory promotion and support services, a deep reform of the regulatory and legislative environment aiming at a leap forward in the realisation of a “Single Market for investment” and a Capital Market Union in Europe.

b) It is market-oriented, and directed at promoting investment that is financed in the market, or through the market, minimizing therefore the risk of wasteful public “white elephants”.

c) It gives a key role to financial institutions and financial services, which are expected to contribute by channelling savings, evaluating and managing risk through screening and scoring of investment projects, and mobilising and extending the available resources through leverage and maturity matching.

d) It is inspired by the subsidiarity principle (both horizontal and vertical subsidiarity), making sure that the public sector does not displace and crowd out the private sector. In the logic of the Plan in fact, the public sector - by providing guarantees - takes on risks that the private sector would not be able to take (risk taker of last resort).

There is only a problem in the Plan, and it is a dramatically relevant one. The fact is that the Plan focuses on measures aiming at structural and supply-side reforms. This is well grounded in theory and practise. But as we all know, structural reforms achieve results normally only in the medium-long term, while the European economy needs today sufficient and credible signals and stimuli operating from the “demand side”. There is in other terms in the present plight of the European economy a cyclical, and therefore temporary, shortfall in demand, that requires a short term boost. An injection of aggregate demand that is capable of recreating confidence and reverse expectations of the economic agents, convincing them that the time for investment decision is (not

later, but) **now**. Unfortunately in the Juncker Plan, at least at first sight, there seems to be nothing of this sort, i.e. no element capable of counteracting the confidence crisis, i.e. acting from the “demand side”.

But we believe that this obvious, and much criticized, weakness of the Plan, can be addressed and corrected. This can be done by making use of the flexibility clause in the Plan.

5. Exploit the flexibility clause in the Juncker Plan

A very relevant aspect of the Juncker Plan is in the **flexibility clause** that it foresees. It in fact envisages the possibility for member states to contribute to the Fund (EFSI) with their own resources, and provides in return the benefit of excluding these member states’ contributions from the constraints of the Stability and Growth Pact. Please note that this clause, fully justified by the exceptional circumstances of the short-term downside and deflationary prospects of the European economy, has nothing to do with the so-called “Golden Rule”, which in the past gave rise to heated and divisive discussions. The reality of the Stability Pact is that if some forms of controlled and limited flexibility are not provided it will itself engender, thorough depression and deflation, instability and financial distress. Therefore, this aspect of the Juncker Plan has to be welcomed and appropriately operationalised.

As will be indicated below, we believe that this feature of the Juncker Plan may play a key role and become an instrument for enhancing the financial resources of the Plan. Many analysts in fact have considered the financial resources of the Plan inadequate to the current needs of the European economy. Others more specifically have criticized the Plan as being too timid in terms of size of own resources, and too bold with reference to leverage. The suggestions detailed below are highly relevant to respond to these criticisms and avoid the repetition of the mistakes (and the lack of success) of the “Growth Initiative” announced in 2012.

Here is how we propose to interpret and complement the Plan, in order to give it also the capacity to impress a short term boost to investors’ confidence:

1. Transfer resources from member states to EFSI, applying the non-inclusion clause relative to the Stability and Growth Pact. The corresponding amounts should be included in a kind of counter-guarantee Fund to be used pro-quota by the contributing member states to guarantee national programs of support to SMEs investment and

assure “European” conditions (we assume that an AAA rating will be attributed to EFSI, borrowing it from EIB) to such national programs. This Fund, on a rotating basis, should work exactly like the Guarantee Schemes for EU mandates that are going to be transferred to EFSI from the EIB.

2. Like in the previous case, member states could, on a voluntary basis, transfer resources to EFSI not only to extend guarantees for investment funding, but also to finance a wider, immediate impact and temporary, cyclical program of incentives to private investments through tax cuts, in short a tax credit on investment (possibly) targeted to SMEs. In other terms, a member state may decide to transfer resources to EFSI for an amount equivalent to a tax cuts program in favour of investment (e.g. tax credits). In so doing the member state takes on the burden of additional debt, but this extra debt “is looked upon favourably” at the EU level, i.e. the flexibility clause applies and the additional debt is not counted for the purpose of the Stability Pact. The mechanism could also work in an alternative way: companies pay their taxes, but the member state transfers tax revenues that are earmarked for investment incentives to EFSI. The Fund in turn gives this incentive back to the companies, after checking - based on documented evidence- that the investment outlays have been carried out correctly, and that the eligibility criteria have been fulfilled, etc. Therefore, it is EFSI that defines criteria, manages certifies and controls the incentive program, but the funding comes from the member state. In this way the credibility of the program is enhanced, the risk of spreading tax incentives too thinly and indiscriminately is avoided, and a rigorous and neutral assessment of the investment process is put in place. Moreover, the technical feasibility of this tool could be subordinated to its segregation vis-à-vis the other compartments of ESFI, so that it does not impact on its rating.

6. A European Programme of Investment Tax Credits

Such a proposal, whose details have to be carefully analysed and spelled out, would have undoubtedly advantages both at the European level and at the level of the member states involved.

At the European level such a measure would provide a clear and strong cyclical backstop to the short term outlook. It would be flexible, because it is left to the free decision of individual countries on the basis of their specific economic situation and requirements. It would not bend the obligations and the parameters of the Stability Pact,

but only make use of a flexibility arrangement, justified by the current exceptional situation of deflationary risks.

The temporary increase of debt, that the tax cuts create, would be a burden only on the specific country concerned (no moral hazard), and would have to be recovered later, when the imbalance is redressed by returning within the limits of the Stability Pact. Finally, it would be politically important for Europe to be associated, for a change, in the eyes of the investors that benefit from the measure (particularly the SMEs), to a program of tax reductions and support to investment, rather than austerity, i.e. to policies geared towards economic growth and jobs.

For member states as well, and we are obviously thinking of Italy as a strong candidate for applying this measure, there would be many advantages. The proposal would make it possible to adopt an expansionary measure without affecting public budget constraints and the credibility of the European stabilization strategy. The fiscal push would be based on tax cuts, rather than on increases in public spending.

From the point of view of governance, the mechanism would be managed centrally and rigorously by EFSI, and would be based on the free choice of the single country concerned. There would be in other terms a transfer of sovereignty, and possibly an improvement in the programme management with likely gains in effectiveness and transparency.

Naturally this opportunity and “openness” in the implementation of the Juncker plan should be adequately argued and explained in order to avoid misconceptions and misunderstandings. It does not imply in fact any relaxation or bending of the criteria of the Stability Pact and it would not result in moral hazard. It would simply create flexibility in relation to the situation of exceptional economic difficulty, that endanger today the achievement of the objective itself of financial stabilization.

Besides, in order to guarantee an appropriate standard of administration transparency and control, the measure implies a transfer of prerogatives and controls from the national level to the European one. There would be no increase in debt, and no cross country transfer of debts at the European level. Only - temporarily and exceptionally – the national debt of the country in question would increase. Therefore it would have nothing to do with the (permanent) exclusion of some kind or type of public expenditure from the Maastricht criteria (the so called golden rule).

The Italian Presidency of EU should exercise all its influence and moral suasion to well explain and argue these concepts in order to dispel suspicion and mistrust from creditor countries, and public opinion. Moreover, countries that intend to use the flexibility

clause in the way we are suggesting should create their own National Funds for Strategic Investment, which would then be passed on to the European Fund. The relationship between the National and the European Fund should be fine-tuned to strike the right balance between national requirements and central credibility.

7. Strengthen the investment capacity of the European economy and society

Channelling financial resources towards investment is not a sufficient condition to bolster capital accumulation.. The Juncker Plan in its second pillar rightly points out that a major effort is required to get sound projects going, i.e. investment projects that can be financed either through taxation (public investment) or through the market (private investment) or through a Private Public Partnership (PPP). The Plan identifies various mechanisms, which in principle we believe could have real value added. Among them:

- a partnership between the EIB and the EC to provide support and carry out projects.
- an investment **advisory hub** based on a single portal for promoters, investors and public managing authorities.
- strengthening the network of National Promotional Banks, and similar bodies across Europe.
- intergovernmental cooperation to collect, strengthen and prioritise projects at national level, building on the work done under the leadership of the Italian EU Presidency by the **EIB – EC Task Force** with member states

We recognise and support the importance of this effort and the various mechanisms that have been proposed. But we underline three essential conditions that need to be taken into account:

1) more than “hubs”, “portals”, partnerships and networks **we need a single, fully-fledged “system” of advisory promotional support services**, with a clear strategic orientation, lean cost-effective structure and real coordination powers. We need to avoid overlaps, duplication and bureaucracy; apply the subsidiarity principle (also when it suggest to bring at EU level functions that are now fragmented and

ineffective¹); rationalize and simplify existing institutions; streamline the use of the limited public resources available.

2) **Rely on the private sector and the market for advisory promotional and support services, including the possible role of business association.** The financial sector has in that context a lot to offer, thanks to its screening and risk assessment capacity, its multiple and varied distribution system; its different business models

3) **Invest in education and training.** We need a new, more advanced and more European “investment culture”, particularly for younger generations. This culture is not a raw material, but should be developed through education and training.

8. Build a “Single Market” for Investment, that is really “Single” and really “European”

The third pillar of the Juncker Plan is the most ambitious and fundamental one. Without an investment environment that is able to energise and mobilise investment by all decision makers, at all levels, including households, SMEs and local communities, the Juncker Plan will not reach its long term objectives of stimulating economic growth and fighting unemployment .

Ultimately an investment inducive environment implies nothing less than a “Single Market for Investment” in Europe. Therefore we could say that this objective is not new, just a reformulation of that distant and comprehensive goal adopted in 1992 (the **single market**) and re-launched at several occasions through waves of liberalisation and re-regulation (lastly with the Monti Report of 2010).

However, the fact that more than 20 years on from 1992, barriers and obstacles to investment have not been eliminated, and that in some case they may have even been increased (e.g in the case of banks after the crisis and **before** the Banking Union) shows how challenging is this part of the Juncker Plan. Basically, we need to learn from past failures and success. In particular, the experience with the Banking Union is very relevant to understand what are the stumbling blocks to reform and how we can make progress (the establishment of the Banking Union was in retrospect relatively fast and smooth).

¹ In the report that we produced in cooperation with Chatham House (Building Growth in Europe, Innovative Financing for Infrastructure) we suggest creating a European Agency on Public Private Partnerships

Based on the lesson learned, we believe that **3 aspects** of the Juncker Plan under this pillar deserve strong endorsement and support, and that **3 conditions** have to be realised if we want the Plan to achieve its stated goals.

The 3 important acquis are the following:

- 1) Move rapidly and effectively towards achieving a Capital Markets Union;
- 2) Remove barriers in the infrastructure sectors identified in the Plan, namely the financial sector, telecommunications and the digital economy, energy, transport, services and related sectors.
- 3) Make the regulatory environment simple, clear, predictable and stable. Administrative burdens and regulatory complexity affect negatively investment, particularly by SMEs, and - in the global competition to attract funding- they penalize our continent.

But there are 3 further conditions, which we have to keep in mind if we want really to achieve success:

1. A single market requires a single rulebook! “Single” should be understood here to mean what it means in plain English: i.e. “single”, not an additional layer of common principles or a set of general rules that is added up, on top of 28 separate regulatory regimes.

Harmonisation is a step forward, but is not sufficient for a single market. Harmonised rules will create harmonised (but separate) markets, not a single market. Moreover, it risks adding to the regulatory burden (e.g. in the case of gold plating) and producing duplication overlaps and confusion.

The same principle (single institutional mechanisms for a single market) should be said of supervision, resolution and guarantee mechanisms.

The implications of the “single rulebook” principle are wide-ranging and should be pursued with realism, gradualism, but also strong determination.

2. All investment sectors should be considered (not only the most obvious and open ones), including in the list those of national (and local) champions, special interests and government monopolies, such as research and universities, welfare systems, media and television, etc.

3. **The institutional architecture matters.** Like in the financial sector, to consolidate in a single (set of) authorities the powers that are now fragmented across a myriad of national and local institutions, would be a great and necessary step forward.

In sum the litmus test for the single market to work can be considered to be two-fold:

- 1) Eliminate barriers, encourage players and resources to move freely across borders, make the market more open and larger, the institutional framework lighter, the regulatory environment simpler and more effective.
- 2) Transfer powers and prerogatives from the national level to the level of the European single market.

We look forward to seeing the 2015 Commission Work Programme, and stand ready to continuing collaboration at the national and European level and promotion of partnerships ideas and proposals from the private sector, in order to contribute to this ambitious and timely programme for re-launching investment, and with it, growth and jobs in the EU.

Rome, December 2014