EUROPEAN COMMISSION

MEMO

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Green paper on long-term financing of the European economy - Frequently Asked Questions

See also IP/13/274

1. What is the objective of the Green Paper?

The purpose of the Green Paper is to start a broad debate on how to foster the supply of long-term financing and how to improve and diversify the system of financial intermediation for long-term investment in Europe.

Putting Europe back on the path of strong, smart and sustainable growth, creating jobs and enhancing its competitiveness in the global market are pressing challenges for which long-term investment is needed. However, at a time of fiscal consolidation and risk aversion by both households and businesses, the supply of finance needed to pay for these investments is curtailed.

The intermediation process, by which the supply of funding is channelled towards investment, is also under pressure, especially with commercial banks – the traditional financial intermediaries in Europe (over 75% of total intermediation) – deleveraging and widespread criticism that incentives in the financial system are misaligned, biased towards short-termism and speculation.

The reasons for this situation are complex and multidimensional and the problem is gaining increasing attention internationally – it is under discussion by the G20 and a range of international organisations including the OECD, the World Bank and the Financial Stability Board.

Europe needs to continue building on its crisis and post-crisis response, complementing the Europe 2020 and other strategies, looking beyond the stabilisation phase in our financial regulatory reform. Possible follow-up to this Green Paper could take several forms: in some areas a regulatory approach may be needed, while in other areas stronger coordination and the promotion of best practices among Member States could be encouraged, for example in the context of the European semester. The responses to this consultation by stakeholders will be extremely valuable in shaping more concretely this follow-up.

2. What does long term financing mean?

There is no single definition of long-term financing. In this Green Paper it is considered as spending that enhances the productive and industrial capacity of the economy. This covers a wide range of tangible assets such as energy, transport and communication infrastructures, industrial and service facilities, housing and climate change, eco-innovation technologies and intangible assets such as education and research & development.

The capacity of the economy to provide the financing for long-term investment depends on its ability to generate savings and attract and retain foreign direct investments (FDI).

3. Who are the savers and the investors when we talk about long term investment?

In Europe, the ratios of investment or savings to GDP are both around 20%. This is favourable compared to other regions. However, this overall picture hides the fact that private investments in 2011 were well below their 2007 level and this drop was four times more than the drop in real GDP over the same period.

Both savers and investors are currently experiencing high degrees of uncertainty, risk aversion and lack of confidence as a result of the weak macroeconomic situation and outlook:

Governments are likely to continue to be constrained by heavy indebtedness. Fiscal consolidation reduces their ability to fund large-scale projects, calling for greater private participation in government investment.

Corporates: Subdued demand and market uncertainties have affected corporate investments and their financing through internal sources. While many SMEs suffer from a continual lack of liquidity, large corporates in some Member States have increased their stock of internal savings.

Households are the main source of funds to finance investment. However, households generally prefer liquidity and easy redemption. There is therefore a need to find ways to mobilise more long-term savings.

External financing: FDI (Foreign Direct Investment) is another traditionally-important source of financing long-term projects but its development in the EU has been quite volatile: after falling to nearly half of the volume in 2008, they picked up again in 2009 but then shrank considerably again in 2010.

4. Are banks not lending as they used to?

In Europe, 85% of financing is provided through banks, but banks today are receiving or will receive amounts of state aid close to 36.7% of EU GDP (or around €4.5 trillion) of which €1.6 trillion (13.1% of EU 27 GDP) have been effectively mobilized.

The loan-to-deposit ratio in Europe was 130% on average in 2011, whereas it was 75% in the US (from 95% at the onset of the crisis).

The crisis highlighted the risks associated with making excessive use of leverage and maturity transformation. Along with weakening demand in some countries in recession, this has led to deleveraging by many banks, contributing in particular to the current scarcity of long-term financing.

Another consequence of the crisis is a growing debate on whether additional reforms directly targeted at the structure of banks would further reduce the probability and impact of failure, better ensure the continuation of vital economic functions and better protect vulnerable retail clients. In this respect, the recent report of the High-level Expert Group on reforming the structure of the EU banking sector recommended restricting and separating out risky trading practices, and the Commission is currently reflecting on how to follow up on the Group's report (IP/12/1048).

Commercial banks which are retail banks providing basic services, such as accepting deposits, providing business loans and investment products will, of course, not disappear from the intermediation chain in Europe. Their credit risk assessment skills, local knowledge of the market, and their relationships with enterprises mean they will continue to be and need to be important players. But against the background of changes in the banking sector, there are new opportunities for other actors such as national and multilateral development banks and institutional investors to complement the role of banks by channelling financing to long-term investments in a more balanced way.

5. How can national and multilateral development banks contribute to long term financing?

National and multilateral development banks which are financial institutions created by a country or multilateral organisation, and which provide financing for the purposes of economic development can play a role in helping to catalyse long-term financing and enhance the efficiency and effectiveness of financial markets and instruments.

Long term financing from these institutions can be achieved, either directly or indirectly, by offering or contributing to a range of financing products, including sharing and/or guaranteeing risks, and bringing together financial intermediaries in appropriate networks. The Green Paper seeks the views of stakeholders on closer cooperation and coordination between national and multilateral development banks, under the aegis of the Commission and/or the European Investment Bank (EIB)

It is also important that public intervention does not contribute to the fragmentation of the Single Market. Coordination, assessment and accountability between actions taken at national and EU-level can help present this, enhancing the value added of a European approach.

6. What is the role of institutional investors in long-term financing?

Institutional investors, such as life insurance companies and pension funds, are suitable providers of long-term financing given the longer time horizons of their business models and their size since they hold an estimated total of €13.8 trillion of assets (or more than 100% of EU GDP).

The long duration of their liabilities allows institutional investors, at least in principle, to buy-and-hold investments in long-dated productive assets, achieving higher yields to offset longer-term risks and lower liquidity inherent in many of these assets.

There may be scope to consider initiatives designed to pool financial resources and to structure financing packages according to different phases of risk. For example, the European Commission has already committed to make proposals on long-term investment funds (see IP/12/1054 – Single Market Act II), which will help institutional investors with diversification and risk spreading. The Commission is keen to know stakeholders' views on initiatives to foster institutional investor participation in the long-term financing of the economy.

7. Has prudential regulation had an impact on long term finance?

In response to the financial crisis, the EU has been pursuing a comprehensive programme of financial reform. When taking stock of all enacted and planned future changes to prudential regulations addressing the various financial actors (banks, insurers, pension providers etc.), an important question is whether their cumulative impact on long-term macroeconomic capital formation could be greater than the simple sum of effects of each reform taken in isolation. For example, if banks reduce their exposure to long-term real assets as a consequence of increasing liquidity requirements, institutional investors with long-term liabilities could fill the gap as long as the regulatory framework avoids an excessive focus on short-term volatility. However, the simultaneous introduction of liquidity requirements for different financial market players may discourage investments in less liquid assets and hence block several possible financing channels for long-term investment at the same time.

This calls for a close monitoring of any cumulative effects of prudential reforms. International regulatory bodies such as the Financial Stability Board and the G20 Group of Finance Ministers and Central Banks are already looking into this. The challenge consists in achieving the regulatory goals of greater macro-financial stability and global regulatory convergence in a way that minimises any negative incentives for financing productive long-term investment.

8. To what extent could European bond markets provide funds in the long run?

European bond markets have developed remarkably strongly over the last years. For example, debt securities issued by non-financial corporates in the euro area from being have risen from €652 billion in 2008 to €940 billion in 2012). However, non-financial corporate bonds in Europe still account for only 15% of corporate debt compared to other economies. The Commission has proposed reforms to improve market structure through the creation of new trading venues; to enhance transparency and information efficiency; to improve requirements to reduce short-term and speculative trading activities; and to increase investor protection[1]. Potential avenues for improving the functioning of bond markets in Europe could include:

- Reducing the fragmentation along national lines of covered bond markets, which have nonetheless proved to be resilient during the crisis;
- Developing securitisation markets, but this would need to be subject to adequate oversight and data transparency;
- Promoting of the use of project bonds to create a true European project bond market that would help unlock further sources of long term finance (by addressing market imperfections and creditworthiness considerations).

The Commission is open to other potential avenues for improvement.

[1] http://ec.europa.eu/internal_market/top_layer/financial_capital/index_en.htm

9. What is the role of equity investment?

The claim exists that the economy, businesses and investment projects need more equity (more asset ownership) in their balance sheets, rather than more debt. Equity can be a better financing instrument for long-term, high-risk investments, as well as for investments with significant information asymmetries and moral hazard. Since the crisis, macroeconomic uncertainty and the low interest rate environment may have affected companies' demand and risk appetite for long-term equity capital. Investors have instead sought refuge in government debt instruments with strong creditworthiness. In parallel, market windows for IPOs (initial public offering; the first sale of stock by a private company to the public) have become smaller than ever, limiting companies' access to capital and European stock exchanges increasingly play a role as providers of liquidity, rather than fresh capital.

The Commission is interested in knowing whether stakeholders share this concern on the lack of equity.

10. To what extent does taxation have an influence on long-term investment?

The structure and level of taxation can have an impact on investment and saving decisions and therefore on growth.

There are three dimensions of taxation that can be considered:

- Tax and investment: Corporate income taxation (CIT) in most Member States tends to favour debt over equity, creating incentives for higher leverage for firms.
- Tax and savings: the taxation of savings affects the total amount of savings in the economy thereby influencing capital allocation and investment.
- Tax incentives: a tax subsidy might be justified when the social return on an investment is higher than the private return of the investor even though these can also create administrative burdens.

11. Do accounting principles and information and reporting influence long-term investment?

Accounting is not neutral but it helps provide a common language between entrepreneurs, investors and public authorities. The Green Paper asks about the merits of examining whether these standards are fit for purpose when it comes to long-term investment.

In a similar way, there are concerns that generic requirements for disclosure might not be enough to stimulate decisions on long-term investments and even that quarterly reporting creates the wrong incentives, pushing market participants to focus on short-term results. The development of metrics and ratings that balance fostering a long-term perspective with short-term accountability could provide a useful tool. Other ideas put forward from stakeholders in the context of the consultation would be analysed with interest by the Commission.

12. What can corporate governance do to stimulate long-term finance?

The way in which assets are managed can play an important role in long-term financing in terms of aligning incentives for asset managers, investors and companies on long-term strategies, mitigating concerns around short-termism, speculation and agency relationships.

Encouraging greater long-term shareholder engagement via increased voting rights or dividends to long-term investors are some options that this Green Paper addresses in order to know the opinion of stakeholders.

Other ideas from stakeholders on improving corporate governance and hence the focus on the long-term are welcome.

13. What other cross-cutting factors enable long-term saving and financing?

Some Member States have taken action to promote long-term saving and investment decisions by households. Auto-enrolment retirement schemes have been adopted in some countries. Others have introduced targeted savings accounts to support the financing of long-term investment projects, providing a (government) guaranteed fixed return and in some cases with certain tax concessions. For example, the *livret A* in France, the *libretti postali* in Italy; and the *Bausparvertrag* (contractual savings for housing finance) in Germany. The funds in these accounts are then invested in public goods such as hospitals, social housing and universities. In the longer term, it may be worth considering whether the availability of specific vehicles at EU level could help mobilise greater longer-term savings, more directly linked to wider societal objectives. This model would need to be adapted in order to be applicable at the EU level and the opinion of stakeholders on this would be very valuable.

14. Can SMEs easily access long term finance?

There are many proposals on the table to foster the financing of SMEs, but these measures may not be sufficient to address the difficulties of SMEs' access to equity. In addition, equity finance can prove fundamental for SMEs since the lending capacity of banks is currently reduced. Further steps could be considered, including:

- Venture capital: In addition to the new rules on European Venture Capital Funds and European Social Entrepreneurship Funds which create a special EU passport for all operators that invest in start-up SMEs and social businesses, funds-of-funds could be efficient instruments to increase the volume of venture capital;
- Dedicated markets for SMEs. Developing frameworks for business networks could favour SME pooling;
- New securitisation instruments for SMEs by, for example providing a European label for vehicles for structured credits;
- Standards for credit scoring assessments of SMEs, and
- Other "non-traditional" sources of finance such as leasing; supply chain finance; internet based sources of finance like crowd-funding, etc.

Other ideas from stakeholders on further steps will be extremely useful in the context of this consultation.

15. What are the next steps?

Stakeholders are invited to submit their contributions by 25 June. On the basis of the outcome of this consultation, the Commission will consider the appropriate actions to be further pursued. The responses received will be available on the Commission website unless confidentiality is specifically requested, and the Commission will publish a summary of the results of the consultation shortly after.

More information:

http://ec.europa.eu/internal_market/top_layer/financial_capital/index_en.htm

ANNEX

Questions asked in the Green Paper:

1) Do you agree with the analysis out above regarding the supply and characteristics of long-term financing?

2) Do you have a view on the most appropriate definition of long-term financing?

3) Given the evolving nature of the banking sector, going forward, what role do you see for banks in the channelling of financing to long-term investments?

4) How could the role of national and multilateral development banks best support the financing of long-term investment? Is there scope for greater coordination between these banks in the pursuit of EU policy goals? How could financial instruments under the EU budget better support the financing of long-term investment in sustainable growth?

5) Are there other public policy tools and frameworks that can support the financing of long-term investment?

6) To what extent and how can institutional investors play a greater role in the changing landscape of long-term financing?

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

8) What are the barriers to creating pooled investment vehicles? Could platforms be developed at the EU level?

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

10) Are there any cumulative impacts of current and planned prudential reforms on the level and cyclicality of aggregate long-term investment and how significant are they? How could any impact be best addressed?

11) How could capital market financing of long-term investment be improved in Europe?

12) How can capital markets help fill the equity gap in Europe? What should change in the way market-based intermediation operates to ensure that the financing can better flow to long-term investments, better support the financing of long-term investment in economically-, socially- and environmentally-sustainable growth and ensuring adequate protection for investors and consumers?

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

14) How could the securitisation market in the EU be revived in order to achieve the right balance between financial stability and the need to improve maturity transformation by the financial system?

15) What are the merits of the various models for a specific savings account available within the EU level? Could an EU model be designed?

16) What type of CIT reforms could improve investment conditions by removing distortions between debt and equity?

17) 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?

18) Which types of corporate tax incentives are beneficial? What measures could be used to deal with the risks of arbitrage when exemptions/incentives are granted for specific activities?

19) Would deeper tax coordination in the EU support the financing of long-term investment?

20) 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?

21) What kind of incentives could help promote better long-term shareholder engagement?

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

23) Is there a need to revisit the definition of fiduciary duty in the context of long-term financing?

24) To what extent can increased integration of financial and non-financial information help provide a clearer overview of a company's long-term performance, and contribute to better investment decision-making?

25) Is there a need to develop specific long-term benchmarks?

26) What further steps could be envisaged, in terms of EU regulation or other reforms, to facilitate SME access to alternative sources of finance?

27) How could securitisation instruments for SMEs be designed? What are the best ways to use securitisation in order to mobilise financial intermediaries' capital for additional lending/investments to SMEs?

28) Would there be merit in creating a fully separate and distinct approach for SME markets? How and by whom could a market be developed for SMEs, including for securitised products specifically designed for SMEs' financing needs?

29) Would an EU regulatory framework help or hinder the development of this alternative non-bank source of finance for SMEs? What reforms could help support their continued growth?

30) In addition to the analysis and potential measures set out in this Green Paper, what else could contribute to the long-term financing of the European economy?