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Correction de la fonte d'un paragraphe (après le cadre contenant les questions 6, 7, 8 et 9).
Concerne toutes les langues.

GREEN PAPER

LONG-TERM FINANCING OF THE EUROPEAN ECONOMY

(Text with EEA relevance)

{SWD(2013) 76 final}

1. INTRODUCTION

Europe's pressing challenge is to 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.

In responding to this task, Europe faces large-scale, long-term investment needs, in line with the priorities of the Europe 2020 strategy,¹ the 2012 industrial policy update², the Innovation Union initiative³ and the Connecting Europe Facility.⁴ Long-term investment is the formation of long-lived capital, covering tangible assets (such as energy, transport and communication infrastructures, industrial and service facilities, housing and climate change and eco-innovation technologies) and intangible assets (such as education and research and development) that boost innovation and competitiveness. Many of these investments have wider public benefits, since they generate greater returns for society as a whole by supporting essential services and improving living standards. Their impact can also begin to be felt in the short term. They enable companies and governments to produce more with fewer resources, responding to new economic, social⁵ and environmental challenges, facilitating the transition to a more sustainable economy and raising the productive and industrial capacity of the economy. Trends in climate change and the depletion of natural resources further underline the sustainable growth challenge, as they call for more long-term investment in low-carbon energy, energy and resource efficiency and infrastructure, consistent with the political objective of limiting climate change below two degrees and decoupling economic growth from resource use.

To fund these long-term investments, governments and businesses of all sizes need access to predictable, long-term financing. The capacity of the economy to make such long-term financing available depends on the ability of the financial system to channel the savings of governments, corporates and households effectively and efficiently to the right users and uses through open and competitive markets. This can be carried out by various intermediaries (e.g. banks, insurers and pension funds) and by direct access to capital markets. This Green Paper focuses on how this process operates. As a prerequisite to channelling long-term financing at reasonable cost, the economy needs to generate and attract savings. Government policies can support this through sound fiscal policies, efficient tax systems and a business-friendly environment that fosters the attractiveness of the economy for investment, including from abroad.

Getting the long-term financing process right is central to supporting structural economic reform and returning to the long-run trend of economic growth. Long-term financing is also needed throughout the whole lifecycle of a company, helping to start a business, allowing it to grow and then sustaining its growth. Long-term financing supports the transition of companies as they progress through this lifecycle. This requires the knowledge and availability of different financial instruments and processes. Long-term financing also helps in the financing of exports and thus contributes to improving external competitiveness. The

¹ See http://ec.europa.eu/europe2020/index_en.htm

² See <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0582:FIN:EN:PDF>

³ See <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0546:FIN:EN:PDF>

⁴ See http://ec.europa.eu/bepa/pdf/cef_brochure.pdf

⁵ The Commission Communication "Towards Social investment for Growth and Cohesion" (COM(2013)83) underlines the need for Member States to make more use of innovative approaches to financing in the social area, including by using participation of the private sector.

importance of long-term financing for growth and job creation has been recognized at international level by the G20.⁶

The financial crisis has affected the ability of the financial sector in Europe to channel savings to long-term investment needs. Above all, the financial crisis and the current weak macroeconomic situation have created a climate of uncertainty and risk aversion, particularly in those Member States under financial pressure and for SMEs. The financial crisis has impaired banks' ability to lend at long maturities, as they need to deleverage, correcting the excesses of the past. At the same time, the crisis has had a negative impact on the confidence and risk appetite of borrowers and institutional investors.

One main lesson of the crisis is that appropriate regulation and supervision of the financial sector is necessary to restore financial stability and confidence in the markets. As part of a broader policy response, it is appropriate to ensure that the detailed calibration of the new regulatory and supervisory framework most effectively enables the financial sector to support the real economy, without jeopardising financial stability.

Looking beyond the financial crisis, an important question is whether Europe's historically heavy dependence on bank intermediation in financing long-term investment will give way to a more diversified system with significantly higher shares of direct capital market financing and greater involvement of institutional investors and alternative financial markets. There is no doubt that, given their risk management skills and local knowledge of and relationships with enterprises, banks will continue to be important players in channelling long-term investment. However, it is uncertain whether commercial banks will resume their practice of holding long-term assets to maturity at previous levels.

The diminished role of banks in long-term lending opens up new needs and opportunities for other financial institutions and market-based intermediation to channel financing to long-term investments. However, the ability of institutional investors and markets to fill this gap depends on a number of conditions. Alongside the right calibration of the prudential regulatory framework, many claim that accounting principles, valuation measurements and the behaviour of asset managers create extra costs and misaligned incentives. In addition, corporate bond, equity and securitisation markets in Europe remain relatively underdeveloped compared to other economies, and non-bank financing remains largely inaccessible to SMEs.

Ensuring effective and efficient intermediation channels for long-term financing is a complex and multi-dimensional task. The purpose of this Green Paper is to initiate a broad debate about 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. As can be seen from the consultation questions, this debate should take into account the specificities of different financial market actors and also address questions related to a diverse set of enabling conditions. Responses to consultation questions will contribute to further assessment by the Commission of the barriers to long-term financing, with a view to identifying possible policy actions to overcome them. Possible follow-up could take several forms: in some areas new or adapted regulation may be needed, while in others the role of the EU level could be in encouraging stronger coordination and the promotion of best practices, or in the form of specific follow-up with individual Member States in the context of the European semester. This Green Paper is accompanied by a Commission Staff Working Paper, setting out the underpinning analysis in more detail.

⁶ See <http://www.g20.org/news/20130216/781212902.html>

2. THE SUPPLY OF LONG-TERM FINANCING AND CHARACTERISTICS OF LONG-TERM INVESTMENT

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).

Various providers can act as the sources of long-term financing, including governments, corporates and households. Governments and corporates also create demand for long-term financing. 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.⁷ 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. This may have lasting effects, creating more permanent barriers to the supply long-term financing, as well as affecting demand:

- **Governments:** public resources, coming from taxation and public debt, play a key role in financing long-term investments given the positive externalities often associated with government investment and its complementarities with private investment. While governments will always play a key role in the provision of public goods and public infrastructure, greater spending efficiency through more systematic cost-benefit analysis and careful project screening has been a long-standing challenge. In addition, public resources in the form of grants or loans are used to support private-sector long-term investment in areas where market failures lead to sub-optimal levels of private funding and/or investment. In these areas, public resources should not replace private financing, but can catalyse it and help manage the associated risks.;
- **Corporates:** Corporates finance investment either from their own resources or by accessing the financial system. Subdued demand and market uncertainties have affected corporate earnings. At the same time, corporate investment has been even weaker, resulting in an increase, in some Member States, in the stock of internal savings, especially of large corporates – cash and equivalent positions of large firms are estimated to have increased by around four percentage points from 2009 to 2011.⁸ However, many SMEs also suffer from a continual lack of liquidity;
- **Households:** Households are the main source of funds to finance investment. However, short-term savings are their most preferred instrument. For example, over the period 2000-2010, households reduced their equity holdings by eight percentage points as a proportion of financial assets.⁹ Households generally prefer liquidity and easy redemption. Stability is preferred and risk-aversion is now widespread. There is therefore a need to mobilise more long-term savings; and
- **External financing:** FDI remains another traditionally-important source of financing long-term projects. Despite the crisis, FDI flows into the EU made a recovery in 2011, after the steep decline of the most recent years. EU inward

⁷ See McKinsey Global Institute (2012).

⁸ Based on a survey of changes in cash and cash equivalents of 170 large European non-financial corporates rated by Fitch.

⁹ See McKinsey Global Institute (2011).

FDI flows reached €242 billion in 2011, thus growing by 13% relative to 2010 levels. Within the EU, there are substantial cross-country disparities.

The long-term growth prospects of any economy depend inter alia on the financial sector's ability to channel the above-mentioned sources of savings into **productive investment**. This Green Paper is concerned with long-term investment in the sense of the formation of long-lived tangible and intangible capital. The focus is thus on productive (as opposed to financial) capital similar to the concept of the national accounts in which investment is specified as gross fixed capital formation. The formation of productive capital was deeply hit during the financial crisis, and investment levels are still below their pre-crisis levels in many EU countries. Investment in tangible and intangible productive capital is essential in order to turn the EU economy around and will be a corner stone of any long-term growth strategy.

The focus is put on long-lived capital goods (such as economic and social infrastructure, buildings and R&D, education and innovation), not because they are more important for growth than shorter-lived capital goods (such as computers, mobile phones and vehicles). Rather, investment volumes for short-lived capital goods are strongly pro-cyclical. These volumes are currently down because of the weak macroeconomic outlook in Europe, but they are expected to recover as soon as the economy picks up. The same is true for other expenses of productive firms such as staff costs (hiring) and purchases of intermediate inputs.

The situation is very different for long-term capital goods, which are characterised by long investment/construction periods and require **long-term financing** given that the cash flows generating the return on investment only start after a considerable period of time. Since a significant share of the stock of long-term productive capital consists of public infrastructure, this type of capital has traditionally played a stabilising role for the economy – this depends on governments being able to provide public investment in an anti-cyclical manner; and the financial sector, when providing funds for investment, being reasonably confident that the economy will be in full swing once construction periods are completed.

There is no single, universally-accepted definition of long-term financing. In broad terms, long-term financing can be considered as the process by which the financial system provides the funding to pay for investments that stretch over an extended time period. This definition focuses on the range of features associated with long-term finance.¹⁰ Alternatively, on-going international work under the auspices of the G20 on long-term investment defines long-term finance more narrowly, focusing on maturities of financing in excess of five years, including sources of financing that have no specific maturity (e.g. equities).

Questions:

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. ENHANCING THE LONG-TERM FINANCING OF THE EUROPEAN ECONOMY

As for all types of financing, the capacity of the economy to finance long-term investment depends on the ability of the financial system to effectively and efficiently channel these

¹⁰ These features include the characteristics of the investor, the nature of the asset, the type of financial intermediation, and the valuation and pricing of the asset. For further details, see the Staff Working Paper accompanying this Green Paper.

funds to the right users and investments through open and competitive markets. This process can be carried out by various intermediaries – including banks, insurers and pension funds – and by direct access to financial markets. However, a range of factors restrains them from playing a fully effective long-term financing role. Some of these factors will take longer to address than others.

One main lesson of the crisis is that appropriate regulation and supervision of the financial sector is necessary to restore financial stability and confidence in the markets. The EU has been pursuing a comprehensive programme of financial reform in this context, complementing broader fiscal and economic reform. Financial stability is essential, but alone is insufficient. As part of a broader policy response, the detailed calibration of the new regulatory and supervisory framework must effectively enable and incentivise the financial sector to support the real economy, including in the area of taxation, without jeopardising financial stability.

Both public authorities and market participants share responsibility for creating this environment, re-embedding confidence and certainty, and enhancing Europe's overall attractiveness as an investment destination. Building on this, **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 to offer long-term financing instruments;**
- **Cross-cutting factors enabling long-term saving and financing; and**
- **The ease of SMEs to access bank and non-bank financing.**

3.1. The capacity of financial institutions to channel long-term finance

Commercial banks

Banks have traditionally been the most important financial intermediaries in Europe. The share of the banking sector in the EU is large by international comparison, especially compared to the US, reflecting Europe's greater dependency on bank intermediation. Going forward, this creates challenges for long-term financing.

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.¹¹ Even once this deleveraging process finishes, the re-pricing of risk following the crisis will raise the cost of capital. The costs associated with bank crisis management tools may also raise the cost of capital, although the positive effects of establishing a more resolvable banking sector will be extremely beneficial for society and the economy. The interconnections between banks and sovereigns and tighter regulation have also amplified the concentration of bank activities in home markets, leading to reductions in cross-border financing and fragmentation of the Single Market, which further reduces the availability of funding and drives up the cost of capital, in particular in countries currently under stress.

¹¹ For example, the ECB bank lending survey October 2012 reports that net tightening of credit standards by euro area banks for loans or credit lines to enterprises increased 15% in net terms, compared to 10% in the second quarter of 2012. Equally, the volume of new long-term loans declined markedly in the first half of 2012 and their stock shows a significant downward trend at the very short end.

Going forward, common European **prudential rules for banks** aim at preventing the excesses of the past, increasing the resilience of banks to risk and instilling confidence, and building a single rule book to protect the integrity of the Single Market. From a long-term financing perspective, prudential regulation must address the risks faced by banks when using short-term deposits to fund long-term lending. It does not follow per se that rules that limit the ability of banks to use short-term funding in this way translate into reduced lending for the real economy. However, 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. Recent 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.¹²

Another consequence of the crisis which may affect the ability of banks to channel long-term financing is the growing debate on whether additional reforms directly targeted at the their structure would further reduce the probability and impact of failure, better ensure the continuation of vital economic functions and better protect vulnerable retail clients. 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, rather than customer-facing activities, including long-term financing for companies. The Group recommended restricting and separating out risky trading practices. The Commission is currently reflecting on how to follow up on the Group's report.

Banks will, of course, not disappear from the intermediation chain in Europe. Their credit risk assessment skills and local knowledge of and relationships with enterprises mean they will continue to and need to be important players. But against the background of developments since the crisis in the banking sector, there are new needs and opportunities for other intermediaries to complement the role of banks by channelling financing to long-term investments in a more balanced way.

Question:

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?

National and multilateral development banks and financial incentives

Development banks active both internationally and nationally should play a role in helping to catalyse long-term financing and enhance the efficiency and effectiveness of financial markets and instruments. Despite the positive net contributions of certain investments to economic welfare, market failures can prevent investors from taking certain risks and/or making certain investment decisions. In these instances, national and multilateral development banks can be useful in stimulating private financing given their specific public policy objectives related to broader economic, social and environmental (as opposed to purely financial) value added. Provided they focus on proven market failures, their involvement can fulfil an important countercyclical role, including by reducing the volatility of funding costs for certain categories of investors and mitigating the short-termism of private actors. Importantly, the governance of development banks should ensure that they do not use their funding-cost advantage to crowd out private financing. Rather, they should strive to catalyse private financing in areas where it is slow to come forward.

¹² See http://ec.europa.eu/internal_market/bank/regcapital/new_proposals_en.htm.

Public intervention can be achieved, either directly or indirectly, by offering or contributing to a range of financing products, including sharing and/or guaranteeing risks,¹³ and bringing together financial intermediaries in appropriate networks.¹⁴ Under the current EU budget a number of the EU-level financial instruments,¹⁵ several run jointly by the Commission, the European Investment Bank (EIB) and the European Investment Fund (EIF), as well as in partnership with Member States, aim at addressing specific market gaps and facilitating access to finance, including longer-term finance.¹⁶ Going forward, the EU multiannual financial framework (MFF) will make increasing use of financial instruments, which can play an important role in increasing the impact of EU spending, by further leveraging and catalysing private long-term financing. In particular, most of the MFF, including all EU Structural Instruments, will be eligible for use in financial instruments. Their effectiveness will depend on close networking and cooperation between the Commission, the EIB Group and Member States.

It is also important that public intervention does not contribute to the fragmentation of the Single Market. Coordination, assessment and accountability between national and EU-level action can help prevent this, enhancing the value added of a European approach. Closer cooperation between national and multilateral development banks, 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. The impact of foreign sovereign funds, and the opportunity to strengthen or create European ones, could also be considered.

Questions:

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?

¹³ For example, ‘bridging products’ are instruments that can ease investors’ or financial institutions’ risk aversion. They can include first-loss credit or mezzanine credit enhancement; vehicles specializing in early-stage and large-scale demonstration projects with public sector financing alongside private sector

¹⁴ For example, through the Long-Term Investors Club. See <http://www.ltic.org/>.

¹⁵ Equity or risk-capital, guarantees or other risk-sharing instruments supported by the central EU budget or the Structural Funds budget. For further details see the Commission Communication “A framework for the next generation of innovative financial instruments - the EU equity and debt platforms” (COM(2011)662).

¹⁶ For example, the Project Bond Initiative and instruments using resources from Structural and Investment Funds providing debt, mezzanine and equity financing to SMEs, municipalities and infrastructure projects. 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 and a Programme for the Competitiveness of Enterprises and SMEs (COSME). The Commission and the EIB have developed two risk-sharing finance facilities, including the Risk-Sharing Finance Facility (RSFF) for research intensive and innovative companies and the Loan Guarantee Instrument for TEN-Transport (LGTT) for transport projects. Under the Structural Funds for the period 2007-2013, at least €10.7bn of EU money has been invested so far in financial engineering instruments, mainly by the ERDF for SME access to finance. This money will be re invested in the long term for the benefit of the European economy.

Institutional investors

Given the longer time horizons of their business models, institutional investors – such as (life) insurance companies, pension funds, mutual funds and endowments – represent suitable providers of long-term financing. Together, they hold an estimated total of €13.8tn of assets, equating to more than 100% of EU GDP.¹⁷ Other institutional investors – such as sovereign wealth funds, dedicated infrastructure funds and, to some extent, private equity – have also emerged as providers of long-term capital. Venture capital can also provide long-term finance.

The long duration of their liabilities allows institutional investors, at least in principle, to make 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. Their longer time horizons enable institutional investors to behave in a patient, counter-cyclical manner, restraining “short-termism” and reducing the need for maturity transformation. The need for diversification and the search for yield given the low interest rate environment have been driving their expansion into long-term financing, allocating substantial shares of their portfolios into long-term instruments such as equity, private equity and other illiquid assets (e.g. some pension funds have invested directly in large-scale renewable energy projects in recent years).

Against this background, as for banks, institutional investors are obliged to meet a variety of prudential regulations and to comply with accounting standards. The new prudential rules for **insurance undertakings** (the Solvency II Directive)¹⁸ 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 and values assets at market-consistent economic value. The impact of new prudential rules on insurers’ long-term financing ability will depend in part on their individual starting point and 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; and, that there is no reduction in the positive incentives of the Solvency II framework on rewarding long-term liabilities duration-matching through long-term investments.

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. Based on these technical findings, the Commission will report on appropriate measures that could be included in the Solvency II Directive or in the related Delegated Acts.

Pension funds need to manage their risks in order to generate the required level of annual returns for their beneficiaries. Pension fund capital rules differ across Member States and differ from those for insurers to take into account the different risks associated with occupational pension funds and the funding resources they may access. The Commission

¹⁷ See Fitch 2011 and EFAMA (2012).

¹⁸ See http://ec.europa.eu/internal_market/insurance/solvency/future/index_en.htm.

plans to review the Institutions for Occupational Retirement Provision (IORPs) Directive.¹⁹ The review aims inter alia to strengthen the protection of scheme members and facilitate cross-border activity in this field. It will be important to ensure that new prudential rules for occupational pension schemes do not discourage sustainable long-term financing. The review of the IORPs Directive will therefore need to take into account the potential impacts on long-term financing and economic growth.

However, beyond prudential rules, a number of other structural factors affect the ability of institutional investors to play a long-term financing role. The economic downturn is likely to have a lasting impact on long-term asset allocation strategies of institutional investors by promoting more conservative investment strategies. For example, the average exposure to infrastructure assets of institutional investors remains low compared to their allocation to real estate and to actual infrastructure investment needs. In terms of risk management and diversification, institutional investors may have concerns around the large scale of long-term investment projects. The asset management functions of non-bank institutional investors may also be unaccustomed to dealing with more illiquid assets, tasks which were previously often carried out by monoline insurers which guaranteed such assets. Over time, this means that some investors may need to extend their existing skills to support their investment decisions.

There may therefore be scope to consider initiatives designed to pool financial resources²⁰ and to structure financing packages according to different phases of risk. Dialogue between investors and non-financial corporates, as well as through the dissemination of good practices and case studies could help here.²¹ The Commission has also already committed²² to make proposals on possible forms of **long-term investment funds** (LTIF). 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.

Questions:

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?*

¹⁹ See http://ec.europa.eu/internal_market/pensions/directive/index_en.htm.

²⁰ 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.

²¹ For example, a finance roundtable has been established to identify opportunities to develop adapted finance and innovative financial instruments for supporting resource-efficiency actions

²² See http://ec.europa.eu/internal_market/smact/index_en.htm.

The combined effects of regulatory reform on financial institutions

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.

Question:

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

3.2. The efficiency and effectiveness of financial markets to offer long-term financing instruments

Alongside institutional investors, well-functioning and deep capital markets and infrastructures are needed to offer a wider range of instruments to channel long-term finance.

European bond markets have developed remarkably strongly over the last few decades.²³ However, non-financial corporate bonds in Europe account still for only 15% of corporate debt compared to other economies. In practice only large corporates have an access to European bond markets, whereas most mid-caps and SMEs are barely able to tap the bond markets. European securitisation markets are also under-developed compared to other parts of the world, further limiting the range of long-term financing instruments available.

The Commission has proposed reforms 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.²⁴ The extent to which these reforms succeed in ensuring that capital markets channel long-term financing as effectively as possible will need to be monitored. Further efforts may be needed.

Covered bond²⁵ markets have proved relatively resilient during the crisis. However, markets are fragmented along national lines and further analysis is required to explore whether and to what extent greater harmonisation could spur the use of covered bonds, in line with recent

²³ For example, aggregate outstanding amounts of debt securities issued by non-financial corporations in the euro area totalled €40bn in July 2012, having risen from about €52bn at the beginning of 2008 (Source: ECB).

²⁴ See http://ec.europa.eu/internal_market/securities/isd/mifid_en.htm.

²⁵ Covered Bonds are bonds backed by pools of mortgages that remain on the issuer's balance sheet, as opposed to mortgage-backed securities, where the assets are taken off the balance sheet.

market-led initiatives while taking due account of the concerns linked to potential increased asset encumbrance of banks' balance sheets.

Reshaping **securitisation markets** could also help unlock additional sources of long-term finance. Subject to appropriate oversight and data transparency, they can help financial institutions free capital, which can then be mobilised for additional lending, and manage risk. Market-based initiatives to stimulate securitisation markets include emerging labels for high-quality, transparent and standardised securitisations. There is scope to develop simple securitisation products based clear and unleveraged structures, using well-selected, diversified and low-risk underlying assets. 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.

The EU as a whole has never had a true **European project bond**²⁶ market. The Commission, together with the EIB, has begun to address this issue by implementing the Project Bond initiative, a financial market solution to address market imperfections and creditworthiness. The initiative seeks to demonstrate the feasibility of bond financing for infrastructure projects and ultimately aim to develop a liquid project bond market. Although still at a small scale, market participants are also developing various investment platforms, products and tools to stimulate project bond markets. There is merit in reflecting on how to promote the use of project bonds further, also taking into account the planned interim evaluation of the initiative.²⁷

Many also claim that the economy, businesses and investment projects need more **equity**, 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 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. Overall, the cost of equity capital has remained high, while the cost of debt finance has fallen. This highlights the equity gap in Europe, which is likely to take time to address. These developments appear to have had a bigger impact on mid-caps. Government policies and regulations need to be as neutral as possible with respect to private agents' choices between equity and debt financing (for example, see below on corporate taxation).

Questions:

- 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?*

²⁶ Project bonds are private debt issued by a project company to finance a specific off-balance-sheet project.

²⁷ 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, including for first-of-a-kind, commercial-scale industrial demonstration projects.

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?

3.3 Cross-cutting factors enabling long-term saving and financing

There are a number of more cross-cutting factors relevant to long-term investment that should also be considered given the impact they can have on both the supply and intermediation of long-term financing.

The actions of public authorities, including taxation regimes, have an important role in inducing 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. Long-term policy frameworks set by public authorities support the development of strategic investment agendas beyond the political cycle, providing greater transparency and increased certainty for investors and corporates. 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.

Some Member States have also 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 accounts²⁸ to support the financing of long-term investment projects, providing a (government) guaranteed fixed return and in some cases with certain tax concessions. 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 the EU level** could help mobilise greater longer-term savings, more directly linked to wider societal objectives. This model would need adapting to be applicable at the EU level.

Valuation measurements, accounting principles and the strategies deployed by asset managers are also cited by many commentators as factors that complicate the intermediation chain, increase the costs of intermediation and create misaligned incentives, such as those arising from the bias towards speculation and short-termism, which are also due to perceived higher risks and delayed returns linked to long-term investment.

Question:

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?

Taxation

The structure and level of taxation can have an impact on investment and savings decisions and therefore on growth. Generally, tax systems should be designed in such a way as to distort as little as possible the economic decisions of citizens and companies, unless the taxes intend to correct externalities arising from specific and well-defined market failures:

²⁸ For example, the *Livret A* in France; the *libretti postali* in Italy; and the *Bausparvertrag* (contractual savings for housing finance) in Germany.

- **Tax and investment:** Corporate income taxation (CIT) is one of many factors influencing decisions over levels of investment, as well as how it is financed. In particular, CIT systems in most Member States tend to favour debt over equity, creating incentives for higher leverage for firms, because interest payments are deductible, while there is generally no such relief for the return on capital. A well-designed tax base that reduces the leverage distortion could also make companies less vulnerable to a short-term reduction in credit. Reforms that try to eliminate this distortion are, however, found 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 and savings:** The taxation of savings has a number of important economic implications, including by affecting the total amount of savings in the economy and thereby influencing capital allocation and investment. Given these effects, tax policies in this area have to be designed carefully. Many Member States have already put in place a number of incentives to increase (long-term) savings, notably with respect to pension-related savings. In addition, many Member States apply dual income tax systems, where capital income is generally taxed separately at a lower rate than other sources of income; and
- **Tax incentives:** Tax incentives are often considered as instruments to encourage certain types of investment; a tax subsidy might be justified when the social return to an investment is higher than the private return of the investor and therefore investment levels are below the social optimum (e.g. R&D and environmental concerns). While there are cases for using tax incentives, they can also create administrative burdens by increasing the number of exemptions or additional rules to be applied. Also, in some cases, the multitude of different national rules may create arbitrage possibilities.

Questions:

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?*

Accounting principles

Accounting is not neutral, it shapes economic decisions: accounting standards and measures (such as the IFRS) help provide a common language between entrepreneurs, investors and public authorities, supporting confidence and safety. This means they have to reconcile different points of view: an economic interest and a financial/investor interest. **Fair value accounting principles** can enhance the transparency and consistency of the financial information since they show the market value of assets and liabilities and provide information on the relative financial condition of different institutions. But it may also be detrimental to stability and long-term financing horizon. For example, some research highlights a reduction by institutional investors 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. There is merit in examining further whether these standards are fit for purpose when it comes to long-term investment. In this context, it would be useful to identify ways to balance the accuracy of the information given to investors with sufficient incentives to hold and manage very long-term assets.

Question:

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?*

Corporate governance arrangements

The way in which assets are managed can play an important role in long-term financing in terms of aligning the incentives of asset managers, investors and companies on long-term strategies, mitigating concerns around short-termism, speculation and agency relationships. Rules are already in place as regards fiduciary duties, conflicts of interest, remuneration, the exercise of voting rights and cost disclosures, and the provision of investment advice and portfolio management.²⁹ Further action is also described in the **Action Plan on European company law and corporate governance**,³⁰ including through possible modifications to the shareholders' rights Directive. Additional steps could 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. 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 increased voting rights or dividends to long-term investors.

Questions:

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?*

Information and reporting

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. Generic requirements for disclosure 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. Non-financial disclosure by asset managers and owners may also merit further reflection, including on how to reflect the specific risks and impacts linked to sustainability in portfolio management. Many commentators also consider that **quarterly reporting** creates the wrong incentives, pushing market participants

²⁹ See http://ec.europa.eu/internal_market/investment/ucits_directive_en.htm and http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm.

³⁰ See http://ec.europa.eu/internal_market/company/docs/modern/121212_company-law-corporate-governance-action-plan_en.pdf.

to focus on very short-term results. In the review of the Transparency Directive,³¹ the Commission has proposed lifting the obligation for quarterly reporting.

Benchmarks and **credit ratings** may focus also on annual or short horizons. The Commission has proposed tightening the rules to reduce reliance on traditional ratings and political agreement was reached on several legislative reforms in November 2012.³² 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.

Questions:

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?

3.4 The ease of SMEs to access bank and non-bank financing

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. Given their reliance on bank financing, these difficulties are reinforced given bank deleveraging. In addition, they are now faced with fragmented financial markets in the EU, as access to finance conditions vary considerably from country to country.

The reduced availability of bank finance has already spurred policy action to promote the development of alternative, non-bank channels for SME lending. In 2011, the Commission adopted an action plan to address the financing problems faced by SMEs.³³ Certain initiatives have already been agreed, including new EU frameworks for investment in venture capital and in social entrepreneurship funds. Some policy initiatives are also underway to facilitate SMEs' access to equity markets. However, other legislative proposals linked to the action plan have yet to be adopted. 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.³⁴ In parallel, there has been growth in long-standing markets, such as asset finance and supply-chain finance, as well as financial innovations making use of technology and the internet, for example through crowd-funding.

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

- **Developing venture capital.** The venture capital sector suffers from lack of resources and is influenced by bank and insurance prudential regulation. Funds-of-funds could be efficient instruments to increase the volume of venture capital. A fund of guarantees for institutional investors could further reduce the constraints in this market;

³¹ See http://ec.europa.eu/internal_market/securities/docs/transparency/modifying-proposal/20111025-provisional-proposal_en.pdf.

³² See http://ec.europa.eu/internal_market/securities/agencies/index_en.htm.

³³ See http://ec.europa.eu/enterprise/policies/finance/files/com-2011-870_en.pdf.

³⁴ See http://ec.europa.eu/internal_market/securities/prospectus/index_en.htm.

- **Developing dedicated markets and networks for SMEs.** Venture capital funds are also dependant on well-performing SME-oriented stock exchanges to turn their investments into initial public offerings. Measures could include creating a distinct approach for SMEs, going further than the current MiFID II proposal, and include the development of specific accounting rules for listed SMEs and new trading platforms. Dedicated SME markets could help raise their visibility, attract new investors and support the development of new SME securitisation instruments. Developing frameworks for business networks could favour SME pooling, risk sharing, mutualisation and diversification and thus improve their access to finance;
- **Developing new securitisation instruments for SMEs.** The Commission already has a SME securitisation instrument in place and has proposed to continue offering support for securitisation through the COSME programme. In addition, under EU criteria for SMEs' industrial investments of European interest, vehicles for structured credits could receive European labels. In view of the wide differences between industrial sectors and between investment cycles, these instruments should be differentiated;
- **Developing standards for credit scoring assessments of SMEs** could help address the lack of reliable information about SMEs and the related difficulty for potential investors in evaluating their credit worthiness. Developing common 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
- **Developing or promoting other "non-traditional" sources of finance**, such as leasing; supply chain finance; internet-based sources of funding like crowd-funding, etc. Further reflection is needed about how to ensure these markets grow on a sustainable basis and are properly supported within a regulatory framework.

Questions:

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 sources of finance for SMEs? What reforms could help support their continued growth?*

Question:

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?*

4. NEXT STEPS

On the basis of the outcome of this consultation, the Commission will consider the appropriate actions to pursue further. 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.

Stakeholders are invited to send their comments by 25 June 2013 to the following email address: markt-consultation-long-term-financing@ec.europa.eu