Financial Inclusion Flash

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Economic Analysis

Financial Inclusion

Financial Systems

Regulation & Public Policies

The Commission on Long-Term Financing of the European Economy

Background

On 27 March, the European Commission published a report on the long-term financing of the European economy. The fourteen-page report is a summary of the problem and future actions, with special focus on SME and PPPs, where in a context of bank deleveraging, uncertainty and risk aversion have reduced funding and increased their preference for liquidity. This has affected economic agents' ability to finance themselves at long maturities, resulting in a suboptimal level of long-term investment and financing. In order to overcome the current situation, the Commission presents its assessment and proposed actions in five areas: mobilizing private sources of long-term financing; making better use of public finance; developing capital markets; improving SME's access to financing; attracting private finance to infrastructure; and enhancing the overall environment for sustainable finance.

Mobilising private sources of long-term financing

The report discusses the current limitations of different source of funding, looking for a diversified and efficient way to mobilise long-term finance. With respect to **banks,** the analysis notes the key importance of the Capital Requirement Regulation (CRR), the Capital Requirement Directive (CRD IV) and the banking reform (particularly banking union) for restoring confidence in the financial sector. However, the Commission is aware of the potential unintended consequences on long-term financing of tightened liquidity rules derived from the Liquidity Coverage Ratio (LCR) and the current international discussion on the Net Stable Fund Ratio (NSFR). It emphasised the need to strike the right balance between improving the resilience of the banking sector to liquidity shocks and avoiding excessive restrictions on maturity transformation that discourage long-term financing. In this regard, **the action proposed** by the Commission is to prepare reports on the appropriateness of the CRR requirements, and to take the fullest account of the preparation of the Delegated Act on LCR and the final calibration of NSFR relating to long-term financing by 2014 and 2015.

Regarding **insurance companies,** the Commission recommends that insurers should be free to invest in any type of asset (particularly for less liquid asset classes) as long as they are able to properly identify and measure the risks associated with such assets based on Solvency II Directives. In this regard, the European Insurance and Occupational Pensions Authority (EIOPA) recommends new criteria defining high-quality securitisation with a more favorable treatment for such instruments by lowering the corresponding stress factors. Likewise, the *Omnibus II Directive* will reinforce existing incentives to match long-term liabilities with long-term assets. The list of eligible assets for the use of the matching adjustment includes some key long-term investments such as infrastructure project bonds. The **action proposed** by this report is to adopt by the latest September 2014 the Delegate Act for Solvency II, including the incentives to stimulate long-term investment by insurers.

The Commission welcomes that **pension funds** are increasingly turning to alternative investments such as private equity and infrastructure to diversify portfolios and provide higher returns. In accordance with this, the recent IORP 2 proposal adopted by the Commission could contribute to more long-term investment by occupational pension funds by limiting the possibilities for Member States to restrict certain types of long-term investment. Likewise, the Commission invited EIOPA to prepare technical advice on the potential or personal pension funds to participate in long-term investment. The **action proposed** is to issue a comprehensive Call for Advice to EIOPA in the second half of 2014 in order to pursue a single market for personal pensions to mobilise more long-term financing.

Making better use of public funding

The Commission notes the potential contribution of the public sector to improving the ideal framework for promoting long-term financing. Also it emphasises the need to ensure more transparent and efficient use of public funds. In this context, the commission highlights the importance of **National Promotional Banks (NPBs), Multilateral Development Banks (MDBs) and Export Credit Agencies** as key players in catalysing and acting as guarantors of risk for long-term financing. With regard to the former, the Commission notes their role in dealing with situations where market failures could be improved. Thus the main **action** stated by the Commission is to provide guidance on general principles of governance and transparency in 2014, as well as encouraging the cooperation of NPBs and MDBs. With regard to the latter, the report underscores the key importance of credit agencies for supporting exports of capital goods outside the EU. The main **action**, in this case, will be to publish a report on promoting better coordination and cooperation among existing national export credit schemes.

Developing European capital markets

The Commission notes that the efforts at the EU level to promote financing channels for large corporates, SMEs and midcap enterprises should be a priority, especially when banks are not prepared to provide credit.

In the case of **equity and corporate bond markets**, one source of concern for the COM is the limited number of IPOs compared with the pre-crisis period, mainly in terms of possible reduction of job-creation. Likewise, the report notes that the main problem in corporate bond markets is that these instruments are not easily available for SMEs despite the creation of local markets for retail bonds in some European countries. The proposed **action** in this regard is a proposal to reduce the administrative costs for issuers, and to reduce the information disclosure requirements for SMEs; and allow UCITS and ELTIFs to invest in SMEs, even if these enterprises are not listed in regulated markets.

The Commission recognises the important role played by high-quality securitisation as a key instrument for releasing funding to finance of the economy.

However, the report points out that certain types of securitisation models were insufficiently or inadequately regulated in the past, although this problem has already been addressed by the development of risk-retention requirements in the EU banking sector since 2011 and the reinforcement of disclosure obligations. The **action** recommended in this case is to develop positive measures, especially the differentiation of “high” quality securitisation products across financial sectors and possible preferential regulatory treatment compatible with prudential principles and the initiative (together with BIS and IOSCO) to introduce global risk standards on rules on risk retention, standardisation of high-quality securitisation products and transparency.

On **covered bonds,** the Commission’s action will be to review their treatment in the CRR with a view to establishing the basic framework for an integrated European covered bond market and in the case of private placements it will study the development of these markets in Europe.

Improving SMES access to financing

According to the report, the high dependence of SMEs on bank funding made them extremely vulnerable when bank credit was frozen during the crisis, especially in peripheral countries. Therefore, it is crucial to reinforce non-bank funding sources for SMEs in Europe. In this respect, the COM paper discusses the importance of providing SMEs with different types of financing as they progress through their life cycle, other than bank credit. The report also stresses the importance of providing more advice and assistance to SMEs on accessing non-bank finance, mainly to prepare SMEs' access the capital markets, and considers the lack of adequate, comparable, reliable and readily available credit information on SMEs, which makes them more dependent on bank funding. Thus, the **actions** recommended by the Commission are to carry out a study on the EU and national legislation and practices affecting the availability of SME credit information, looking at the feasibility of increasing the comparability of data across the EU. It will also assess best practices on helping SMEs to access the capital markets

Attracting private finance to infrastructure delivering Europe 2020

The Commission encourages adjudicating authorities to consider private-sector involvement in infrastructure projects, by employing full-life cycle and prudential analysis of value for money and to promote bids from the private sector, based on a wider range of financing options. It also mentions the improvements to the Project Bond Initiative (PBI) and the possible extension to other infrastructure sectors. Likewise, it notes that improving the availability of transparent information and data on new Public Private Partnership (PPP) projects could equally attract institutional investors to European projects. So, the main **action** recommended is to improve information for European infrastructure projects and funding sources.

Enhancing the wider framework for sustainable finance

The Commission notes that a large majority of corporate tax systems in Europe favour debt financing rather than equity because the former allows deduction of interest expenses, while equity financing does not. Likewise, differing accounting standards, taxation and legal requirements make it difficult for businesses with cross-border activities in the EU to finance themselves, particularly SMEs. On this point, the Commission recommends incentivising equity investment in particular for Member States with a high debt bias in corporate taxation. Likewise, it suggests the development of best practices to enable the early restructuring of viable enterprises and to allow bankrupt entrepreneurs to have a second chance.

Our assessment of the proposal

Overall, the proposals formulated in the document for stimulating long-term financing are steps in the right direction. However, if we take into account the variety of possible funding sources it seems that not all of them will be implemented at the same speed, which could frustrate the Commission's ambitious goals. For instance, in the case of insurance funding, in recent months EIOPA has made impressive progress with the publication of Solvency II directives and significant advances in setting favorable regulation for the acquisition of long-term unconventional assets. However, on pension funding, the institution itself has not yet proposed such ambitious measures, and is still far from optimising the participation of pensions in long-term investments because of the enormous differences between Member States' perspectives.

Regarding the financing of infrastructure projects, the Commission should notice some success such as in Australia, the USA, Canada and Chile, where pension funds have been very active during the last two decades without experiencing any difficulties but fulfilling an important countercyclical role in those geographies during the current financial crisis. It will also be important to learn from the success of other multilateral organisations around the world on their success in implementing mitigation risk mechanisms for the financing of infrastructure projects.

With respect to SMEs access to funding, although the measures included in the paper are positive, the key is to promote bank lending. In this context, measures to facilitate loan restructuring in order to avoid viable firms going bankrupt should be promoted. As for non-bank funding, tax incentives should be given to investors in listed SMEs, or SMEs' debt.

On securitisation, we welcome the work to differentiate "high" quality securitization products with a view to exploring a possible preferential regulatory treatment and the attention paid to global consistency, given the Commission's plan of working with the international standard-setters to develop and implement global standards, especially on regulations regarding risk retention, high-quality standardisation and transparency. We consider that current revisions to the Basel Securitisation Framework should be discussed at those meetings as they could entail increases in capital requirements, particularly for high-quality securitisations. But these political aims have to be translated into concrete measures as soon as possible not to deter the revival of securitisation activity. Ongoing delegated acts by European Commission related to LCR or Solvency II would be the right place for those political statements to become reality in the form of regulations that do not penalise holding high-quality securitization assets in comparison to alternative funding sources.