European Economic and Social Committee

ECO/347
Long-term financing - financial services sector

Brussels, 10 July 2013

OPINION

of the
European Economic and Social Committee
on the
Green Paper on long-term financing of the European economy
COM(2013) 150 final/2

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Rapporteur: **Mr Michael Smyth**

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Rue Belliard/Belliardstraat 99 — 1040 Bruxelles/Brussel — BELGIQUE/BELGIË
Tel. +32 25469011 — Fax +32 25134893 — Internet: http://www.eesc.europa.eu

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On 25 March 2013 the European Commission decided to consult the European Economic and Social Committee, under Article 304 of the Treaty on the Functioning of the European Union, on the

Green Paper on long-term financing of the European economy
COM(2013) 150 final/2.

The Section for Economic and Monetary Union and Economic and Social Cohesion, which was responsible for preparing the Committee's work on the subject, adopted its opinion on 19 June 2013.

At its 491st plenary session, held on 10 and 11 July 20131 (meeting of10 July 2013), the European Economic and Social Committee adopted the following opinion by 151 votes to 3 with 3 abstentions.

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1. **Conclusions and recommendations**

1.1 One of the most important elements of a strategy to get Europe back on a path of sustainable growth is securing an adequate supply of long-term finance at reasonable cost. The Commission's consultative document on this issue is both welcome and timely.

1.2 The EESC welcomes the Green Paper's focus on productive investment and the formation of long-lived tangible and intangible capital but urges the Commission to give greater attention to the need to finance more "socially useful" capital investment.

1.3 If banks are likely to play a less prominent role in the future as providers of long-term financing, then opportunities may arise for other intermediaries such as national and multilateral development banks, institutional investors, sovereign funds and, crucially, bond markets. However, it is important to avoid creating obstacles that prevent banks from fulfilling their role as the main providers of long-term financing, and that a legal framework be in place that avoids driving financing and capital flows outside the regulated sector.

1.4 The EESC welcomes the recent recapitalisation of the EIB as this will strengthen its ability to leverage additional private investment finance and to play a stronger countercyclical role in investment funding and credit supply to SMEs. While a €10 billion capital injection is significant the EESC considers it to be short of what is needed in the present circumstances.

1.5 Similarly the arrival of EU 2020 Project Bonds, albeit in a pilot phase, is also a positive development. These Project Bonds were developed jointly by the Commission and the EIB. Consideration should also be given to similar joint ventures with sovereign funds.

1.6 If initiatives such as Project Bonds succeed in expanding the market for bond finance they should be ramped up once the pilot phase is completed and evaluated.

1.7 The Green Paper examines the role of savings in the supply of long-term investment finance. While some Member States have embarked on special savings schemes to mobilise longer-term savings hypothecated to wider social investments, the creation of an EU or eurozone wide savings vehicle, perhaps offering an interest rate premium may be worth considering.

1.8 Some Member States have been relatively successful in incentivising pension related and other savings by astute use of the taxation system. Citizens tend to balk at the prospect of paying tax on income earned and then more tax on long-term savings out of this post-tax income. In the context of socially responsible investment, it should be possible to design and market suitable low or zero tax personal savings products with appropriate annual limits so as to encourage greater long-term financial planning.

1.9 Short-termism in the financial system has been a major impediment to the provision of adequate long-term investment and is closely linked to corporate governance. Changing the incentives to promote long-term performance is not an easy challenge. The EESC welcomes the Commission's suggestions about enhanced voting rights and dividends for long-term investors and changes to the shareholders' rights directive. In addition, consideration could be given to a co-ordinated use of capital gains tax allowances to incentivise longer-term shareholding by fund managers.

1.10 In terms of venture capital the Green Paper contains some interesting suggestions. The EESC has already proposed that the EIF's role should be enlarged beyond providing loans to include the provision of venture capital. This was what its creators originally envisaged back in 1994. If the EIF, like the EIB, were to be adequately recapitalised then it could become one of the main providers venture finance for SMEs.

1.11 Finally, given that national and regional governments are already in the business of promoting the survival and long-term growth of SMEs through their regional development bodies, there is a case for these bodies to take on a role in the operation of such SME trading platforms. This role could range from assessing the credit worthiness of client SMEs to providing limited guarantees to institutional investors.

1.12 The EESC would like to see greater emphasis placed on socially responsible investment and proposes the establishment of an observatory to monitor long-term investment conditions.

2. Introduction and background to the Green Paper

2.1 The main motivation of the European Commission in producing this Green Paper is the need to get Europe back on the path of growth that is smart, sustainable and inclusive. Europe is facing major long-term, large-scale investment requirements as the basis for sustainable growth. Achieving this is severely complicated by the current risk aversion of households and businesses and the need for fiscal consolidation by many governments which together are restricting the supply of longer term investment finance.

2.2 Failures in the traditional channels of financial intermediation are currently problematical. Banks have been the main source of investment finance in the EU but many of them are now primarily engaged in deleveraging and are thus not able to fulfil their normal role. The Green Paper looks beyond the current crisis, searching for solutions to the provision of the necessary long-term finance for investment.

2.3 The Commission's focus is on productive investment and the formation of long-lived tangible and intangible capital which tends to be less procyclical than shorter lived capital. The Commission defines long-term financing as the way in which the financial system pays for investments that have a long project life.

2.4 Europe has undertaken a programme of reform of the financial sector so as to provide greater stability and confidence in financial markets. The stability of the financial system is a necessary condition for the encouragement of long-term investment but it is not a sufficient condition. The Commission identifies a number of additional areas where action is needed such as:

- the capacity of financial institutions to channel long-term finance for projects;
- the efficiency and effectiveness of financial markets to offer long-term financing instruments;
- policies to encourage longer term saving and investment; and
- the ability of SMEs to more readily access both bank and non-bank finance.

3. Comments on the proposals

3.1 *Capacity of financial institutions to channel long-term finance for projects*

3.1.1 Commercial banks. The Commission's analysis of the challenges in securing adequate long-term finance in Europe is fundamentally correct. The traditional pre-eminence of banks as the main providers of long-term financing is changing and banks may play a less prominent role in the future. There is no discussion about the potential inconsistency between some new banking regulations and the aims of the Green Paper to stimulate long-term investment. The Green Paper notes merely that the effects of recent and likely future financial reforms may reduce the level of activity of banks in the intermediation chain. A better balance should be struck between the prudential requirements of Basel III and the incentives for banks to continue to provide long-term investment finance. In any case, opportunities are likely to open up for other types of intermediaries such as national and multilateral development banks, institutional investors, greater use of bond markets and sovereign funds.

3.1.2 National and multilateral development banks. These institutions play an important role in sharing the risk with private investors and operators to develop important projects and thus prevent market failures. They also play a countercyclical role through their longer term strategic actions. The EIB and the EIF have played increasingly prominent roles in risk-sharing and the recent recapitalisation of the EIB, though inadequate in the opinion of the EESC, will undoubtedly strengthen its ability to leverage additional private investment finance. The EESC encourages the EIB to do more to promote major cross-border infrastructure projects which face particular financing obstacles.

3.1.3 The EESC welcomes the creation of EU 2020 Project Bonds and they are now being piloted in a number of PPP infrastructure investment projects in fields of energy, transport and ICT infrastructures[1]. The Commission touches upon the potential role sovereign funds in financing longer term investment. As in the case of Project Bonds which were jointly developed by the Commission and the EIB there may be merit in developing a similar joint initiative with sovereign funds thereby increasing the available pool of longer term investment finance.

3.1.4 On the issue of institutional investors, the Green Paper notes the potential clash between the need for effective regulation of asset risk among insurance undertakings and the need to incentivise them to finance longer term investments. Discussions between the Commission and the European insurance authorities on this matter are on-going. The Commission intends to make proposals on long-term investment funds (LTIF) with a view to stimulating the creation of a number of mechanisms for pooling risks involving different types of institutional investors. This proposal has much to commend it. Pension funds could take a more prominent role in long-term investment but they perceive a number of institutional, regulatory and political obstacles in the way. In particular they are concerned that policymakers attempt to mandate them to finance certain types of project that are not in the interests of their members. Pension funds should be consulted about how to minimise or overcome these obstacles. The creation of a banking union may be helpful in this context.

3.1.4.1 In the context of engendering greater participation of institutional investors in the provision of long-term finance, corporate income taxation incentives could also play a part. A system of tapered allowances in respect of large infrastructure projects investments could lead to greater institutional investor participation in them.

1 See for example COM(2009) 615 final.

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

3.2.1 The Green Paper notes that in order to widen and deepen the pool of long-term finance some capital markets in Europe need to develop and mature. Bond markets in the EU are less developed than in the US and are viewed as off-limits to most mid-caps and SMEs. Even the arrival of Project Bonds has been greeted cautiously by the ratings agencies and this underlines the uphill struggle ahead to grow bond market capacity. If initiatives such as Project Bonds which could create as much as EUR 4.6 billion for new infrastructure projects succeed in expanding the market for bond finance they should be ramped up once the pilot phase is completed and evaluated.

3.3 *Policies to encourage longer term saving and investment*

3.3.1 There is an extensive review of the factors influencing long-term saving in financing. On the supply side, while some Member States have made efforts to boost the supply of long-term savings, much more needs to be done. The Green Paper suggests the possible creation of EU wide savings vehicles designed to mobilise more long-term savings hypothecated to wider social objectives. This idea may have advantages in the context of expanding cross-border infrastructures. It may also stimulate greater labour mobility and retirement planning across the single market. It may be necessary to offer new savings products at a premium or tiered rates of interest to incentivise longer term savings.

3.3.2 Taxation. The relationship between taxation, long-term savings and long-term investment is examined in some detail. The corporate taxation treatment of investment tends to produce a bias towards debt over equity finance. In search of suitable reforms to encourage greater use of equity funding of longer term investments, the use of a tapered relief system may be worth considering. Such systems are widely used in the taxation of capital gains and they could be configured so as to offset some of the current fiscal advantages of debt finance.

3.3.3 In terms of long-term savings and the taxation system, the Commission notes the importance of ensuring a stable, adequate supply of savings and of the incentives necessary to bring forth this supply. Some Member States have been relatively successful in incentivising pension related and other savings by astute use of the taxation system. Citizens tend to balk at the prospect of paying tax on income earned and then more tax on long-term savings out of this post-tax income. It should be possible to design and market suitable low or zero tax personal savings products with appropriate annual limits so as to encourage greater long-term financial planning.

3.3.4 The use of tax incentives to achieve desirable long-term investment outcomes is not without its drawbacks. There are serious issues such as deadweight and arbitrage to deal with. Nevertheless the use of tax incentives within a consistent and robust longer term planning perspective is necessary to stimulate and bring forth desired levels of investment.

3.3.5 Corporate governance. The issue short-termism lies at the heart of the provision of long-term investment and is very much tied up with corporate governance. Hitherto many of the incentives for fund managers, investment bankers and corporate executives have tended to be short-term in nature. Changing these incentives to encourage greater levels of long-term performance will not be an easy task. The Green paper contains a number of interesting suggestions including enhanced voting rights and dividends for long-term investors and modifications to the shareholders rights directive. Perhaps a more proactive use of capital gains tax allowances might be one means of encouraging longer term shareholding by fund managers.

3.4 *The ability of SMEs to more readily access both bank and non-bank finance*

3.4.1 The Green Paper notes the mounting difficulties facing SMEs in many Member States in accessing funding to survive and to grow. Quite apart from the effects of bank deleveraging, SMEs face a fragmented and rather piecemeal set of alternative sources of finance. Local banks have, to a large extent, lost or lessened links to their local regions. Bank-SME relationships have weakened and these need to be rebuilt or strengthened. Several initiatives have been undertaken to provide non-bank sources of finance for SMEs including access to some venture capital funds, the use of asset finance[2], supply chain finance and crowd funding. Much more needs to be done. The insurance industry and pension funds are willing to play a more prominent role but require appropriate incentives and these should now be addressed by the Commission. Future measures to help SMEs to access longer term finance should ensure that the latter are able to benefit from these measures as originally envisaged - without the banks adding excessive additional conditions, if the measures are to be rolled out via bank lending channels.

3.4.2 Venture capital. The Commission suggests a "funds of funds" approach to creating a critical mass of venture capital funding. In addition the proposed fund of guarantees for institutional investors could expand the market. The EESC has already proposed that the EIF's role should be enlarged beyond providing loans to include the provision of venture capital[3]. This was what its creators originally envisaged back in 1994. If the EIF, like the EIB, were to be recapitalised then it could become one of the main providers venture finance for SMEs.

3.4.2.1 Hand-in-hand with the expansion of venture finance for SMEs goes the expansion of existing or the creation of new trading platforms for SME equity finance. The Green Paper contains a number of useful proposals on the subject. Given that national and regional governments are already in the business of promoting the survival and long-term growth of SMEs through their regional development bodies, there is a case for these bodies to take on a role in the operation of such SME trading platforms. This role could range from assessing the credit worthiness of client SMEs to providing limited guarantees to institutional investors.

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2 See for example the *Funding for Lending Scheme* http://www.hm-treasury.gov.uk/ukecon_fundingforlending_index.htm.

3 OJ C 143, 22.5.2012, p. 10.

3.4.3 The EESC would have liked the Green Paper to give greater support to investment in socially responsible funds through the creation of appropriate tax and financial regulations as well as public procurement itself. In this regard there is perhaps a case for the creation of a European Observatory for long-term investment. This body, with the active participation of organised civil society, could monitor developments in both the supply and demand for long-term investment and savings and help ensure an adequate supply of information relevant to sound long-term investment decision-making by economic agents.

Brussels, 10 July 2013

The President
of the
European Economic and Social Committee

Henri Malosse

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