EU Communication

# LONG-TERM FINANCING OF THE EUROPEAN ECONOMY

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Centrum für Europäische Politik

## Key Issues

**Objective of the Communication:** The Commission wants to increase the supply of long-term financing.

**Affected parties:** Banks, insurance companies, savers, regulatory authorities and companies in need of financing.

**Pro:** (1) Diversifying the channels of long-term financing may stimulate the credit supply as long as the risks are sufficiently taken into consideration.

(2) An EU-label for "high-quality securitisations" may rebuild confidence in the securities market.

**Contra:** (1) The Commission ignores the demand-side causes of the lack of long-term investment which will continue without structural reforms to increase competitiveness.

(2) The proposals for encouraging more future investment by insurance companies in infrastructure projects and SME loans, are risky.

(3) A government subsidised "EU savings account" should be avoided. It may lead to less rather than more investment.

## Content

### Title

**Communication COM(2014) 168** of 27 March 2014 on **Long-Term Financing of the European Economy**

### Brief Summary

- **Context and Objective**
  – For the period up to 2020, the Commission sees a need for investment in transport, energy and telecommunications amounting to one billion euro for infrastructure networks of EU-wide importance. It also sees a substantial need for investment in research and development, new technologies and the implementation of the energy and climate package 2030 [COM(2014) 15, see cep**PolicyBrief**] (p. 2).
  – According to the Commission, the financial and economic crisis has resulted (p. 3)
    - on the one hand, in a "suboptimal level" of willingness to invest long-term and
    - on the other hand, a lack of long-term financing caused by a preference for liquidity and bank "deleveraging".
  – The Commission sees "market failures and inefficiencies" in bank lending and wants to bolster other long-term financing channels:
    - mobilising private sources of funding,
    - developing capital markets,
    - amending the existing accounting standards and legal framework and
    - better availability of SME credit information.

- **Mobilising private sources of funding**
  – Bank lending is a crucial factor for funding long-term investments. According to the Commission, the diversification of financing channels is necessary in order to improve the availability of long-term financing and to make the European economy more resilient to crises. (p. 4)
  – As part of the pending reform of the Capital Requirements Regulation for banks [CRR, Regulation (EU) 575/2013, see cep**PolicyBrief**], the Commission wants to set the level of the minimum liquidity quota and the structural liquidity quota such that they do not "unduly" restrict long-term financing by banks. (p. 5)
  – The Solvency II Directive, applicable from 1 January 2016 [2009/138/EC, with amendments by the Omnibus II Directive 2014/51/EU see cep**PolicyBrief**] makes it easier for insurance companies to invest in less liquid assets. The Commission is also considering a reduction of the capital requirements for investments by insurance companies in SMEs and infrastructure projects. (Page 6 and 7)
  – With its proposal for a Directive on occupational pension schemes [IORP II, COM(2014) 167], the Commission wants to improve the possibility for this fund to contribute to long-term investment. It also wants to create a single market for personal pensions and, in this regard, is considering EU rules for the cross-border activity of such schemes or setting up a 29th regime offering an alternative to the existing national rules. (p. 6)

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– By the end of 2014, the Commission wants to carry out a study as to whether "market failures and other shortcomings" are hampering the cross-border "use of savings" in the EU. In the study, it wants to look into the potential of an "EU savings account" and, inter alia, deal with questions about interest rates and deposit guarantee schemes. (p. 7)

► **Development of the European capital markets especially for SMEs**

– According to the Commission, European capital markets for both bonds and equities remain fragmented and unattractive for SMEs. As part of the pending reform of the MiFID II Directive, the Commission wants [Art. 33 Directive 2014/65/EU, see cep**PolicyBrief**] to facilitate SME access to the special market segment created by the Directive, the "SME growth markets", by
  - defining "appropriate criteria" for admission to trading, information to investors and financial reporting in this market segment,
  - minimising the administrative burden for issuing corporate and retail bonds and
  - introducing a minimum proportion of SMEs for all issuers on these markets.

– In order to improve the availability of long-term financing, the Commission wants (p. 9 and 10)
  - to investigate whether investment funds open to private investors (UCITS, Directive 2009/65/EC, see cep**PolicyBrief**) could in future invest in securities listed on SME growth markets that display certain liquidity characteristics,
  - undertake a study on whether the liquidity and transparency of the secondary markets for the trading of corporate bonds should and could be increased (p. 9) and
  - assess, by the end of 2015, whether the disclosure rules in the Prospectus Directive [Directive 2010/73/EU, see cep**PolicyBrief**] for SMEs and other companies with reduced market capitalisation are proportionate (p. 9).

► **Further measures for developing the European capital markets**

– Banks can pool assets such as loans, convert them into tradable securities and sell them on. Such securitisation transactions unlock capital resources and increase a bank's lending potential. The Commission wants (p. 9)
  - to introduce the label "high quality" securitisation products and assess whether lower capital requirements should apply to investments by banks and insurance companies in such securitisations,
  - to work with the international standard setters, in particular the Basel Committee, to develop global standards inter alia on risk retention for securitisation transactions.

– According to the Commission, covered bonds are a cost effective and safe way of financing long-term investments on the capital market.
  - The Commission wants to set up an integrated EU market for covered bonds.
  - By the end of 2014, it will review the extent to which the capital requirements for covered bonds are reasonable. It will launch a study on the merits of introducing an EU framework for covered bonds. (p. 10)

– Private placement allows companies to borrow capital from large investors, such as in the form of a promissory note. By the end of 2014, the Commission wants to conduct a study on private placement markets, analyse the key success drivers for private placements, analyse their risks and develop policy recommendations on how to implement them at EU level. (p. 10)

► **Accounting standards and legal frameworks**

– As part of the endorsement of the accounting standards for financial instruments (IFRS 9), the Commission wants to assess whether the use of a "fair value" which is subject to market fluctuations, reduces the incentives for long-term investment (p. 14).

– The Commission wants to invite the International Accounting Standards Board (IASB) to "give due consideration" to the effect of its decisions on the investment horizons of investors and reintroduce the "concept of prudence" (p. 14).

– Since 2005, listed companies have had to prepare their annual accounts in accordance with the international accounting standards IAS/IFRS [IAS Regulation (EC) No. 1606/2002]. The Commission wants to assess whether the criteria used for including such accounting standards into European law, are obstructing long-term investment in the EU. (p. 15)

– By way of country specific recommendations in the European semester process, the Commission wants to advise the Member States to reduce the tax bias towards debt financed investment as compared with equity investment.

► **Greater availability of information about SMEs**

– According to the Commission, SMEs are often dependent on local bank financing due to the lack of adequate, comparable, reliable and readily available credit information on SMEs. (p. 11)

– In 2014, the Commission wants to undertake the mapping of the legislation governing the availability of credit information on SMEs. (p. 11)

## Policy Context

In March 2013, the Commission published a Green Paper aimed at channelling savings more effectively into long term financing needs. The Economic and Financial Committee of the European Parliament set up a High Level Expert Group, which in its Report of December 2013, presented recommendations as to how infrastructure projects and investments by SMEs could be better financed by the capital market. At the same time as this Communication, the Commission also published a proposal for a Directive on company pension funds [COM(2014) 167] and a Communication on releasing the potential of crowd-funding in the European Union [COM(2014) 172]. On 7 August 2014, the Commission launched a consultation on the International Financial Reporting Standards (IFRS) for the planned reform of the IAS Regulation [EG 1606/2002].

## Options for Influencing the Political Process

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| Directorates General: | DG Internal Market and Services (leading) |
| Committees of the European Parliament: | TBA (leading), Rapporteur TBA |
| Federal Ministries: | Federal Finance Ministry (leading) |
| Committees of the German Bundestag: | Finance Committee (leading); |
| Consultation Procedure (on IAS): | All citizens may express their opinion. The procedure ends on 31 October 2014; http://ec.europa.eu/internal_market/consultations/2014/ifrs/index_de.htm |

# ASSESSMENT

## Economic Impact Assessment

In order to kick off long-term investment one needs both a financier to provide the long-term financing (supply) and a company seeking credit that is willing to undertake long-term investment (demand). **The Commission** seems to be aware of this but in the Communication **only looks at ways of increasing the supply of long-term financing. It ignores the demand-side causes for the lack of long-term investment.** This is problematic because even in Member States where supply-side lending does not suffer from an under-capitalised banking sector, the willingness to make long-term investment is low. The reasons arise, on the one hand, from the uncertain regulatory environment which can, at a stroke, make existing long-term investments uneconomic. Examples of this are the discussion on network neutrality in the field of telecommunications and the uncertainty about the treatment of investments in renewable energy. On the other hand, the continuing erosion of competitiveness plays a major role - particularly in the south of the eurozone. **Without structural reforms to increase competitiveness** - liberalisation of the labour markets, reduction in unit labour costs - little is going to change in this regard and **there will continue to be a lack of long-term investment** (demand) irrespective of the financing conditions (supply). In this regard, though, it is the Member States rather than the EU who need to act.

**The diversification of long-term financing channels,** with the participation of various market players, as proposed by the Commission, **may stimulate credit supply if the risks are correctly represented** in the financing costs. Otherwise there is a risk of credit default which ultimately destroys lenders' equity and thus further inhibits lending.

The proposals are still too vague to provide a conclusive assessment of whether the measures put forward by the Commission - such as setting up a minimum liquidity quota for banks or the preferential regulatory treatment of investments by insurance companies in infrastructure and SMEs - distort the correct pricing of financing risks.

However, **the proposal for encouraging more future investment by insurance companies in infrastructure projects and SME loans,** in particular, **is a risky one** and will not be favoured by the EU Insurance regulator EIOPA. There is actually insufficient data available to work out the consequences of such preferential treatment. What is problematic is the fact that, due to the typically small number of major, long-term infrastructure projects, the risks cannot be sufficiently spread. Although a large number of SME loans are available, they have, depending on the sector, a not insignificant likelihood of default. Against this backdrop, the Commission's proposed reduction in the capital requirements for such investments is risky. In any case, it places additional requirements on the insurance regulator because the risk profile of investments by insurance companies will change. Since insurance companies do not have any protective measures comparable with the deposit guarantee scheme, such commitments by insurance companies should be limited. **A government subsidised "EU savings account" with guaranteed or tax-privileged returns should be avoided. It may lead to less rather than more investment** because, in future, investors will only be willing to take risks if the expected returns are significantly higher than those for the government subsidised accounts. If, in addition, the EU savings account is ear-marked, there is a risk of mis-allocation due to a presumption of knowledge: the legislator ultimately assumes that it knows better than the market how savings should be invested. There is a risk that funding will go to politically desirable projects rather than to those which are economically sound. This type of savings account also involves high risk to the tax payer. In order to attract savings deposits, the guaranteed interest must be significantly above market level which leads to the question of how the bank is to generate these returns. Ultimately, it may be that tax money has to be used to cover interest payments. It should be for the market to determine whether SMEs can obtain finance on the capital market. A flotation or the issue of corporate bonds gives rise to high costs for a company, not least due to the publicity requirements. Until now, therefore, many SMEs have been reluctant to obtain financing via the capital market. However, publicity obligations perform the important function of informing and safeguarding investors. Facilitating SME access to the capital market, such as by relaxing the disclosure rules contained in the Prospectus Directive, makes it more difficult to compare the information of different companies and can thus result in the mis-allocation of capital. Opening up "SME growth markets" for investment funds that are open to private investors (UCITS), may jeopardise financial market stability. The UCITS Directive (2009/65/EC, see cep**PolicyBrief**) rightly restricts the securities investments permitted by UCITS. An important objective of this rule is to safeguard the liquidity of these funds. Thus investors can return their shares in UCITS funds at any time. Extending the permitted assets to include SME securities, which may be unsellable in tight capital market conditions, runs contrary to this safeguard.

In principle, securitisations do have a positive economic effect: by selling their loans, banks have more capital available to provide new lending. **An EU-label for "high-quality securitisations" may rebuild confidence in the securities market** but the choice of criteria which have to be fulfilled by "high-quality securitisations" must be clear and objective. However, the Commission gives the impression that it wants to specifically promote long-term investments. That is misguided: The risks of long-term investments must be given the same level of consideration as that applied to investments with different maturity patterns.

## Legal Assessment

### Legislative Competency

Not yet apparent.

### Subsidiarity

Not yet apparent.

### Proportionality with Respect to Member States

Not yet apparent.

### Compatibility with EU Law in other Respects

Not yet apparent.

### Impact on German Law

Not yet apparent.

## Conclusion

The Commission only looks as considerations for increasing the supply of long-term financing. It ignores the demand-side causes for the lack of long-term investment. However, without structural reforms to increase competitiveness, this lack of long-term investment will continue. The diversification of long-term funding may stimulate the availability of loans as long as the risks are sufficiently taken into consideration. The proposals for encouraging more future investment by insurance companies in infrastructure projects and SME loans, are risky. A government funded "EU savings account" should be avoided. It may lead to less rather than more investment. An EU-label for "high-quality securitisations" may rebuild confidence in the securities market.