EU Green Paper

LONG-TERM FINANCING

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KEY ISSUES

Objective of the Green Paper: The Commission wants to increase financing for long-term investments.

Affected parties: Capital providers, particularly banks, insurance companies and other investors; companies, particularly in the energy, transport and communication sectors and SMEs.

Pro: Investment activity in the EU, particularly for long-term projects, is currently at a critical point. It is appropriate to address this problem.

Contra: (1) Banking regulation must not be undermined by the fact that the less tightly regulated insurance companies and pension funds are permitted, for reasons of political expediency, to take on the financing activities of banks.

(2) Government-backed savings models may lead to less rather than more investment; pose the risk of misallocation and have to be borne by the tax payer.

(3) Preferential treatment for long-term shareholders may be in breach of EU law.

CONTENT

Title

Green Paper COM (2013) 150 of 25 March 2013: **Long-term Financing of the European Union**

Brief Summary

► **Definition, context and objectives**

– "Long-term financing" is the process by which "the financial system provides the funding to pay for investments that stretch over an extended time period" (p. 5).

– The Commission sees a "large-scale need" for long-term investment in (p. 2):
  - "long-lived capital" – e.g. energy, transport and communication infrastructure – and
  - "intangible assets" – e.g. education, research and development.

– According to the Commission, the banking sector has had only a limited ability to channel savings into long-term investment needs since the financial crisis. The reason for this is, in particular (p. 3),
  - "a climate of uncertainty and risk aversion" due to the current economic situation and
  - the banks' compulsion to reduce their debts thereby depleting the availability of long-term credit.

– With the Green Paper, the Commission has initiated a debate about how (p. 3)
  - to foster the supply of long-term financing and
  - how to improve and diversify the system of financial "intermediation" between capital providers and capital seekers.

– According to the Commission, "setting long-term policy frameworks" is essential for investment because they provide "greater transparency and legal certainty" (p. 13).

► **Empirical data**

– An economy's ability to fund long-term investment depends on (p. 4 and p. 5)
  - savings "in public and private budgets and by companies" as well as
  - foreign direct investment (FDI).

– For 20 years, the EU's ratio of savings to GDP - savings as % of GDP - has been a "favourable" 20% (USA: 14%). The savings quota for private households - until now 80% - is currently declining, whereas the quota for large companies is increasing.

– 40% of FDI comes from countries outside the EU and 60% from cross-border investment within the EU. FDI from countries outside the EU collapsed during the crisis but is now recovering. It is currently at 1.7% of EU GDP. [P. 4 and accompanying documents SWD(2013) 76 p. 7 and 8]

► **Impact of prudential regulations in the financial sector**

The Commission asks whether the "current and planned" regulatory reforms in the financial sector will have "significant" impact on the ability to provide long-term financing and wants to examine the "cumulative effects" of regulation (p. 10 and 11).

► **Improving the possibilities for long-term financing**

– **Private households: Models for savings accounts**
  - The Commission asks whether "specific models of savings accounts" or the creation of an "EU savings account" would be appropriate.
  - As an example of such savings account models it mentions (p. 13)
    - obligatory private pension schemes – as in the UK, although they also have an opt-out possibility - ,
    - targeted savings accounts with government guaranteed returns or tax concessions - such as Livrets A in France and libretti postali in Italy – and
    - - as in Germany - the Bausparvertrag (contractual savings for housing finance).

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– **Commercial banks**
  - According to the Commission, banks may, as a result of the financial crisis, award fewer long-term loans because they have to deleverage in order to correct the "excesses of the past" (p. 3). Their capital costs will also rise as a result of new regulations on bank resolution (see cepPolicyBrief). In addition, according to the Commission, the banks are concentrated in home markets and this increases the capital costs for companies in countries which are "under stress". (p. 6)
  - The Commission asks what role the banking sector should have in the channelling of financing to long-term investments (p. 7).
  - The Commission sees "needs and opportunities" to reduce the economy's dependence on traditional bank financing (p. 8).
  - The Commission wants (p. 8)
    - to examine the rules on liquidity levels contained in the capital requirements for banks (see cepMonitor) because it sees a potential conflict between restrictions on liquidity and the provision of long-term financing,
    - to bring in measures to counteract the findings of the Liikan Report which found a "disproportionately large rise" in transactions inside the financial sector at the expense of the long-term financing of real projects outside the financial sector.
– **National and international development banks**
  - The Commission sees development banks as the catalysts for private investment in the public interest, which is slow to come forward due to market failures. They could play an "important anti-cyclical" role and reduce the volatility of funding costs. The Commission also wants to look into the establishment of national and EU sovereign wealth funds (p. 8).
  - The Commission asks (p. 8)
    - how development banks could "best support" the financing of long-term investment,
    - whether there is scope for greater coordination between these banks and
    - how financial instruments under the EU budget – e.g. equity or venture capital and project bonds - could be better used.
– **Institutional investors**
  - According to the Commission, institutional investors – e.g. insurance companies, pension funds, investment funds, endowments – are "well" suited to long-term financing due to their long-term business models (p. 9).
  - The Commission, (p. 9 and 10)
    - following an examination by the European Insurance and Occupational Pensions Authority (EIOPA), wants to decide how capital requirements for insurance companies, should be handled under the Solvency II Directive (see cepPolicyBrief) in the case of long-term commitments and investments ,
    - as part of the review of the IORP Directive on company pensions (2003/41/EC), wants to ensure that the prudential rules for pension funds "do not discourage sustainable long-term financing",
    - wants to develop a "legal framework" for a new category of "investment fund for long-term investments".
  - The Commission asks (p. 10)
    - whether institutional investors could play a "greater role" in relation to long-term financing,
    - how can prudential regulations and the desire to support long-term financing "best be balanced" in the case of both insurers and company and other pension funds.
– **Capital markets**
  - According to the Commission, European bond and securitisation markets are "under-developed" (p. 11).
  - The Commission asks (p. 12-13),
    - how capital market financing could be improved in Europe,
    - whether increasing equity capital could contribute to closing the equity gap in European companies,
    - whether the fragmentation of the covered bonds market "along national lines" could be overcome by greater legal harmonisation,
    - how the securitisation market in the EU could be revived with
      - "market-based initiatives - e.g. quality labels for standardised securitisations –,
      - the development of simple securitisation products based on unleveraged structures and
      - dedicated SME securitisation markets.
  - Together with the European Investment Bank (EIB), the Commission wants to press ahead with the EU initiative on project bonds [Consultation, see cepPolicyBrief; see also Project Bond Initiative COM(2011) 660] in order to create a "liquid" project bond market (p. 12).
    Project bonds are loans to finance infrastructure projects issued by private or public-private project companies and secured by public sector guarantees.

► **Taxation**
– According to the Commission, most tax systems prefer debt over equity. This creates incentives for higher leverage and makes companies vulnerable to credit reductions. (p. 14)
– The Commission asks (p. 17),
  - how corporation tax could be reformed to remove these distortions and create incentives for equity capital formation,

  - what incentives should the Member States set up to encourage long-term saving, and
  - whether "deeper tax coordination" in the EU would be beneficial.
- **Ease of access to financing for SMEs**
  - According to the Commission, small and medium-sized companies (SMEs) in particular have faced difficulties in accessing funding. They are often reliant on banks (p. 16).
  - The Commission asks (p. 16-18),
    - what regulations at EU level could facilitate SME access to alternative sources of finance - e.g. venture capital,
    - how could securitisation instruments for SMEs be designed and best used for gaining access to capital,
    - whether there would be merit in creating special "SME markets" which go further than the "growth markets" contained in the Commission proposal for the MiFID-II Directive (see also cep**PolicyBrief**) and
    - whether an EU regulatory framework for alternative non-bank sources of finance for SMEs would be beneficial.
- **Other proposals**
  - The Commission asks,
    - whether fair value accounting principles have been detrimental to long-term financing and whether there are any alternative concepts (p. 14),
    - whether the long-term involvement of shareholders and asset managers can be enhanced by promising more voting rights and higher dividends to long-term shareholders (p. 15).

Policy Context

At their summit in Moscow in February 2013, the G20 emphasised the importance of long-term financing for growth and employment. The Green Paper is connected to Strategy Europe 2020 [COM (2010) 2020, see cep**PolicyBrief**], the Communication on Industrial Policy [COM (2012) 582], the Flagship Initiative of Strategy Europe 2020, "Innovation Union" [COM (2010) 546, see cep**PolicyBrief**], and the "Connecting Europe" Facility [COM (2011) 665]. In the Green Paper, the Commission also makes reference to the capital requirements for insurance companies [Solvency II, COM (2007) 361, see cep**PolicyBrief**] and to the recently passed capital requirements for banks [COM (2011) 452 and 453, see cep**PolicyBrief**]. Other related items are, inter alia, the Pension Fund Directive (Directive 2003/41/EC), the Single Market Act II [COM (2012) 573], the MiFID Directive [COM (2011) 656, see cep**PolicyBrief**], the UCITS Directive [Directive 2009/65/EC, see cep**PolicyBrief**) and the AIFM Directive [Directive 2011/61/EU, see cep**PolicyBrief**]. Under a current French draft bill, shareholders in France who hold shares for more than two years will in future have their voting rights doubled provided the company memorandum and articles does not specify anything to the contrary.

Options for Influencing the Political Process

Leading Directorate General: GD Single Market

ASSESSMENT

Economic Impact Assessment

Long-term investment, such as in transport, energy or telecommunications infrastructure, promotes growth and employment. They are essential for the prosperity of a society.

Investment activity in the EU, particularly for long-term projects, is currently at a critical point. The EU investment quota, having been stable for years at 20% of EU GDP - and thus above the level in the USA -, has been falling continually since the start of the financial crisis. **There are principally three reasons for this:**

Firstly, the financing of long-term investment projects requires a stable regulatory framework - both for investment projects and for investor activity. This is currently lacking in the EU. If investors fear that investments which have already been made will become uneconomic due to changing conditions, willingness to invest will be inhibited. Years of discussions, and the associated legal uncertainty, such as in relation to the calibration of the liquidity ratio or equity requirements for insurance companies, are an example of this.

Secondly, the poor economic climate and the erosion of the competitiveness of some EU countries give rise to lower investment. The lack of competitiveness can best be overcome by way of structural measures – deregulation of the labour market, reduction of unit labour costs. This would make Europe more attractive to investors and such consolidation would promote the influx of direct investment (FDI) into the EU and/or reduce the outflow of capital from the EU. **It is principally the national governments, rather than the EU or the ECB, that are obliged to step up in this case.** The ECB cannot contribute any more than it already has done to solving the problem. Despite the ECB's drastically low interest rate policy, investment is not rising. On the contrary, in fact, what is growing is the danger of the prospect of rising inflation and thus higher interest rates. That reduces the willingness of capital providers to provide longer term credit.

Thirdly, both stricter bank regulation and overcoming the consequences of the Euro crisis tie up capital, which is no longer available for investment. Thus the stricter capital requirements [COM (2011) 452 and 453, see cep**PolicyBriefs**] and the high write-off requirements of the banks lead to a shortage in the availability of credit. This shortage has to be accepted as the price to be paid for achieving the objective of regulation - a risk-adjusted pricing of loans. Deviating from this objective would in turn jeopardise the stabilisation of the banking sector and should therefore be avoided. **The tightening of the equity requirements for banks,** which was seen as correct in the wake of the crisis, **must not be undermined by the fact that less tightly**

regulated operators such as insurance companies and pension funds are permitted, for reasons of political expediency, to take on the financing activities of banks. The Commission would thereby run counter to its own deliberations in the Green Paper on the regulation of "shadow banks" [COM (2012) 102, see cep**PolicyBrief**]. In this Green Paper it once again criticised the transfer of banking activities to insurance companies and investment funds.

Government-backed "special savings accounts" – such as those with returns which are government guaranteed or subject to tax concessions – **may lead to less rather than more investment.** In future investors will only be willing to take risks if the expected returns are significantly above those for the government backed accounts. Whether this is possible depends not least on the level of the government subsidies. In addition**, in the case of targeted savings accounts, there is a risk of misallocation 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. **Savings accounts models involve high risk to the tax payer.** In order to attract savings deposits, the guaranteed interest must be significantly higher than the market level. This gives rise to the question of how the bank is to generate these returns. **The Commission should** therefore **dispense with government-backed savings accounts.**

"Project bonds" based on public funds, being initiated by the Commission and European Investment Bank (EIB), should only be permitted where the purely private provision of bonds to finance infrastructure is excluded and positive externalities are allowed to arise. Otherwise, purely private bonds should be preferred over those with government backing or guarantees because that is the only way to guarantee that investment takes place based on purely economic criteria.

Alternative sources of capital for SMEs - such as venture capital financing, dedicated securitisation markets and trading venues - may improve their access to the capital market. An abundance of private initiatives are already working on this. If the Commission provides for regulatory concessions in this case, it must be ensured that the provision of capital is always dependent on the risk involved and that the capital provider bears the risk of the loss of its invested capital.

There is no convincing reason to treat long-term investment more favourably than short-term by giving more weight to the voting rights and dividends of long-term investors. It seems likely that, with its proposal, the Commission is aiming to make it more difficult for short-term investors, such as hedge funds, to take over companies. There is, however, no convincing argument for this.

Legal Assessment

Legislative Competency

It is not currently clear on which statutory basis the planned proposal is to be based.

Subsidiarity.

Not currently clear.

Proportionality

Not currently clear.

Other compatibility with EU law

Preferential treatment for long-term shareholders as regards voting rights or dividends **may,** depending on the arrangement, **represent an unlawful restriction on the freedom of movement of capital** (Art. 63 TFEU) **and thus be in breach of EU law.** Such a restriction may be justified by compelling reasons of public interest but not on general economic or business policy grounds. No reasons of public interest are apparent. Whether the other proposals will give rise to problems under EU law is not yet clear.

Impact on German law

There has been a general ban on issuing new shares with multiple voting rights in Germany since 1998 [Section 12 (2) Stock Corporation Act (AktG)]. Previously, ministerial exceptions were possible for the protection of prevailing macroeconomic interests. On the other hand, so-called preference shares may be issued (Section 12 (1), sentence 2 AktG). The owners of such shares have no voting rights but receive higher dividends. The impact of the other proposals on German law is not yet clear.

Conclusion

Investment activity in the EU is currently at a critical point. There are three reasons for this: Firstly, the financing of long-term investment projects requires a stable regulatory framework; this is currently lacking in the EU. Secondly, the fall in investment in the EU is due to the poor economic climate and the erosion of competitiveness; however, it is for the Member States to take action in this regard, not the EU. The third reason is that stricter banking regulation ties up capital; however, this is important and must not be undermined by the fact that the less tightly regulated insurance companies and pension funds are permitted, for reasons of political expediency, to take on the financing activities of banks. Government-backed savings models may lead to less rather than more investment; pose the risk of misallocation and have to be borne by the tax payer. The preferential treatment of long-term shareholders may represent an unlawful restriction on the freedom of movement of capital and thus be in breach of EU law.

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