

INVESTING IN LONG-TERM EUROPE

RE-LAUNCHING FIXED, NETWORK
AND SOCIAL INFRASTRUCTURE

PAOLO GARONNA
EDOARDO REVIGLIO (eds.)

LUISS ACADEMY

Dedicated to Fausto Felli,

*“Novissima autem inimica destruetur mors: omnia enim subiecit sub pedibus eius cum autem dicat”.**

S. Paul, First Epistle to the Corinthians

*“The last enemy that shall be destroyed is death: For He has put everything under His feet”.

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Introduction

Paolo Garonna, Edoardo Reviglio

Finance for Growth

This Volume collects reflections and contributions on the critical link between investment and growth in Europe. It aims at documenting and building on the fundamental shift in policy concepts and frameworks that took place in the EU around the middle of the second decade of this century. This period was defined and characterized by the critical transitions underway: from recession to recovery; from inward looking existential interrogations to irresistible pressure to action and delivery; from the Barroso Commission to that of J.C. Juncker; from depression to market volatility and uncertainty; from domestic political bickering to confronting threatening geo-political instability; from one European legislature to the next.

Useless to remark that financial markets have been at the center of all these transitions. Indeed, to some extent they contributed to the challenges with their own transitions and vulnerabilities. However, something happened that changed the picture. There is a sense that a fundamental discontinuity is determining a break with the past. And the world of finance is at the heart of it. Not only as part of the problem, but above all as part of the solution.

This change of sentiment has come to be encapsulated in the dictum: “finance for growth”!

Finance for growth was introduced as a concept by the Italian leadership of the EU institutions in 2014, at the time when Italy was holding the EU Presidency. But now it has become a European concept and undertaking.

The contributions to this Volume, representing a variety and a wide-range of points of view and perspectives, illustrate how and why the concept of “finance for growth” can be applied, and has been applied to almost all the items in the economic policy agenda of the EU. Austerity and Quantitative Easing; fiscal and monetary policy; flexibility and governance; stability and growth. Also Banking Union and the Capital Markets Union.

But finance for growth means a lot also for the world of business. It has been incorporated and reflected in the business strategies and practices of the private sector, which has taken on its share of responsibility for making markets work better, for looking ahead of the curve, anticipating and preparing for the future.

What does “finance for growth” mean?

First it means focusing on investment. The main collateral damage of the great depression. The necessary bridge between supply and demand, the short-term and the long-term, the present and the future.

It means also focusing on financing and delivery, which requires not only better financing, but also more financing.

The financial sector after the crisis came to be considered the locus of instability inefficiency and unfairness. The political discourse, or we should better say “the populist narrative”, preached for freeing up the economy and society from finance and its tricks, pointing out nostalgically at the beautiful simplicity of the “real economy”, that of the nuts and bolts, that of the rust belt. And “deleveraging” in this context became, not just a healthy and inevitable correction after the excesses of the past, but also a sort of “new way of life”.

Then it came the credit crunch. And the discovery that with the down-sizing of the balance-sheet of financial intermediaries, and central banks, incomes and jobs were affected, not only in the financial sector, but above all in the economy at large.

What would a “world without finance” be like? How much more beautiful, productive and even ethical? ... Not much! As it became soon clear.

Financing is a critical aspect of the investment process. Not only a “condicio sine qua non”. A quantitative constraint. But a guarantee of the quality of investment. The anchor of the present to the sustainability of the future. The essential linkage between those who save, and their interests, and those who spend. The multiplier of opportunities and the promoter of the primacy of the ideas over economic and financial power.

The stakes now have changed. The main issue has become: how do we move on from a credit-less recovery towards a finance-led growth. Finance for growth means developing a model of growth pulled by financial development, rich in financial innovation and education.

The contributions to this Volume explore many of the different aspects and contours of this new world of financial development. Financial development means promoting new sources of financing, complementary to bank credit. It means developing capital markets, insurance, pension funds, venture capital. It means recapitalizing the private business sector, particularly SMEs, encouraging listings, equity, private debt. It means recapitalizing the household sector, to-day exposed in a subtle concealed way to the deterioration of demography and the public debt overhang. Financial development means inaugurating a new partnership and a new division of labor between the public and the private sector, the market and the State.

This problematique was at the center of discussion at the International Conference “Investing in Long-Term Europe. Re-launching Fixed, Network and Social Infrastructure” organized in association with the Italian EU Presidency, held in Rome 12-13 December 2014. Many of the contributions were either presented there or produced around the time of the Conference, and re-worked afterwards. The Conference was jointly organized by the Italian Banking Insurance and Finance Federation, the OECD, the Long-Term Investors Club and Cassa Depositi e Prestiti together with The European Long-Term Investors Association, The Official Monetary and Financial Institutions Fo-

rum, Integrate (a think-tank specialized in social infrastructure) and the Italian Council of the European Movement.

We wish to thank all institutions who have done an exceptional job both in the organization of the event and in the collection of the various contributions presented here. A special word of thanks is also due to the institutions that gave us active support, including the European Commission, the Italian EU Presidency and the Italian Ministry of Economy and Finance. Last but not least, we thank the contributing authors, which shared with us their ideas, passion and enthusiasm.

This Volume owes enormously to our friend and colleague Fausto Felli, the President of Integrate, who worked hard with us in the preparation of the Conference, and afterwards in the collection of the different contributions. Above all Fausto fought to translate the new ideas and suggestions into proposals and practical suggestions that would stimulate further discussion and initiatives, and move on the European agenda towards a better future for all. His passion skill and determination were contagious, and provided an invaluable input. Fausto worked with us until a few days before his sudden and premature death in the summer of 2015. We will miss him a lot.

This book is dedicated to his memory, and to all those who continue pursuing his ideals and his work.

The challenges in the recovery of the European economy

The challenges that Europe will have to face in the next decades are daunting. Burdened by the public debt overhang and the growing demands on – and costs of – the Welfare State, public resources for investment are being squeezed, or at best stagnant. This is largely due to demographics, in-work and out-of-work poverty, growing polarization and segregation, and the scourge of a generation of young people who might never gain a foothold in the labor market.

In this context, the challenges of bridging the infrastructure and investment gaps in Europe appears formidable. Unless we create a new model to finance infrastructure and R&D, based on innovation, new skills and advanced technical tools, the most pressing and urgent requirements of corporates and SMEs cannot be met. It is widely understood and recognized that right now infrastructure and SMEs are the weakest spots in the map of the European vulnerabilities. Therefore supporting and providing long-term finance to these two sectors should be one of the central goals of the EU economic and financial policy.

To this end, we need to develop a model capable of attracting the huge stock of global long-term savings, which seek long-term investment with the right risk/yield profile. A new “asset class” for infrastructure has to materialize in financial markets at the global level, and Europe should be ready to harvest a large enough quota of private savings to channel towards financing of its fixed and social infrastructure needs. It is a huge and ambitious challenge that will be met only if policy makers and industry, both in the financial sector and the so called “real economy”, work together to create a pipeline of sound and meaningful projects, a regulatory framework friendlier to long-term finance and a set of practical long-term financial instruments.

Increasing long-term investment is the crux of the matter for the future of the European economy. This new concept was first introduced at the onset of the financial crisis in 2008-2009. It was then that the first Pan-European Long-Term Greenfield Fund “Marguerite” was launched and the Long-Term Investment Club (LTIC) was created, under the impulse of the EIB together with the major national promotional banks (the German KfW, the French CDC, the Italian CDP). The Club’s members have rapidly increased, and today the Club has a global reach drawing together 18 large financial institutions from all continents of the world with over 5 trillion in asset under management. Moreover, the Club’s initiatives have contributed to building up a growing focus on long-term policy initiatives and activities at the EU level.

At the global level, the concept gained prominence at the center of the G20 Agenda, thanks in particular to the OECD. This organization from the very beginning has invested much time resources and strategic leadership in studying and disseminating the essential features of long-term investment. At the Saint Petersburg G20 Meeting in 2013 – held under the Russian Presidency – the recommendation to increase long-term investment came strong and clear out of the Ministerial proceedings as an essential component of the strategy for sustainable and balanced global growth, and as such it was included for the first time in the agreed conclusions of the Summit.

The need for investing in Long-Term Europe: new approaches and financial instruments

One of the major consequences -and causes- of the European great and long recession has been the fall in investment. It exceeded €550 billion between 2007 and 2014. Such a dramatic decline affected both private and public investment expenditures in all EU economies. It does not come as a surprise therefore that in the response to the recession, investment figures prominently. The EU has maintained and reaffirmed the ambitious policy goals concerning investment of the Lisbon Agenda (2,000 billion euros of investment in transportation, energy and TLC). But it has planned to achieve it mainly through private investment and, for infrastructure projects, through project financing. The idea of financing investment by issuing Eurobonds, which was hardly debated and proved to be highly controversial, has been for the time being set aside. Rather, the primary role in the new strategy has been given to reliance on – and revitalization of- private capital markets and the financial sector. The modernization of European capital markets and new approaches and financial instruments for financing investment has been placed at the heart of the European strategy for consolidating the recovery and stimulating sustained and sustainable growth in the future.

In December 2008 the European Council gave a mandate to the European Commission, the EIB and the largest national European promotional banks (KfW, CDC, CDP, ICO and PKO) to launch a long-term Greenfield Fund for transport, energy and renewables. As mentioned above, this is the Marguerite Fund, which started operations in 2010. In a matter of a few years, this Fund became one of the largest infrastructure-funding vehicle in the EU. As part of the same strategy, in 2012 the EIB launched the Project Bond Initiative (PBI). The underlying idea of the PBI is to create a new financial instrument that facilitates the recourse to the debt capital market for financing

infrastructure projects (“project bonds”). The investment areas involved were the trans-European transport networks (TEN-T), the trans-European energy networks (TEN-E), ICT and broadband. The intention was to expand the financing options for these projects. A new financial instrument was then jointly developed with the EIB, the Project Bond Credit Enhancement (PBCE) facility. This is a subordinated instrument that supports senior project bonds issued by infrastructure project companies. The subordinated tranche functions as a protective layer to the senior tranche, thereby enhancing the credit rating of the bonds issued by the project companies. The Project Bond Initiative pilot phase proved to be quite successful. More than 13 projects were financed through the Initiative, and the demand coming from major long-term institutional investors (pension funds and insurance companies) has been correspondingly very high.

In 2014, the new Commission, created after the 2014 elections to the European Parliament, launched a bold new “European Investment Plan”, better known as the Juncker Plan. The Plan aims at unlocking public and private investments in the real economy for an amount of at least € 315 billion over the next three years (2015-2017), without creating new debt.

The Juncker Plan represents a significant shift in the economic and investment policies of the EU. It represents an in-depth change and a break with the basic philosophy and approach of the past. Alongside with the two Communications on Flexibility and on State Aid Modernization, the general framework has been reformulated and partially revised. New principles were introduced. The first one is the principle of fiscal flexibility – the “investment clause” – which for the first time introduces –albeit timidly– a “flavor” of what in the debate was called the “Golden Rule”, stirring a lot of controversy. In particular, it has been ruled that contributions from Member States to the regional or thematic Platforms, under well-defined – and tight – macroeconomic and fiscal conditions, can be exempted from the application of the Growth and Stability Pact. The second is the principle of additivity (“filling market failures or sub-optimal investment situations”). The third is the principle of “good aid” – defined as “the decision on State aid [that address] well-defined market failures and objectives of general interest”.

The fourth is the “complementarity” of National Promotional Banks with respect to the market, and the recognition of their institutional role as pillars of the European Fund for Strategic Investment (EFSI) alongside the EIB. Such principles can be inscribed well within the limits and the foundations of the current economic constitution of the Union, but contain radical shifts and can be considered also as seeds of potential future constitutional transformations. It has to be underlined that such defining changes are not only indispensable both to promote a stronger Single Market and reduce the competitiveness gap of the European economy, but also would have not been achieved without the impulse and the leadership of the Italian Presidency of the EU in the second half of 2014.

In this new context, the Juncker Plan takes on broader and deeper significance. It is not simply a new large Guarantee Facility for European SMEs and infrastructure. But it should instead be seen “in nuce” as a first tool operating as an anti-cyclical buffer to boost investment and growth in a downturn, and a first step towards a Single European

Market for Infrastructure and SMEs financing. The Plan represents also an opportunity to promote and stimulate ambitious reforms at national level and the revisitation and recalibration of the different processes required for carrying out investment projects. Investment in fact requires much more than improved funding. It needs legislative stability, streamlined and fast administrative procedures, light regulatory burdens, fast and reliable judicial systems, efficient and technically prepared public administration, information platforms, transparency, technical assistance, cutting red tape, etc).

The operational architecture of the Plan is based on the “European Strategic Investment Committee” and on specific Platforms designed at the regional and national as well as sectorial level, so to reach players and projects operating at different levels and in specific sectors. In the Platforms, the National Promotional Banks, together with the EIB, play a fundamental role.

The main idea behind the Plan – as previously mentioned – is that with an aging population, a public debt overhang, and tough competitive economic global challenges, the EU should rely for financing infrastructure and SMEs on a system that weighs as little as possible on public finance. We need new models and tools, technically advanced, as well as financially reliable and standardized. We need to attract long-term investors and private capital flows from around the globe, where liquidity is great, but it is channeled where risk is lower and yield is higher. We need to face up to the prospects that the demand and the competition for capital investment increase at exceptionally high rates, throughout the XXI Century.

On the road to the European Capital Markets Union

The European Commission moves along an ambitious Action Plan geared towards building a Capital Markets Union. In the Communication on CMU, there are listed important steps which that directly involve infrastructure and SMEs financing.

As far as long-term investment is concerned, the “CMU Plan” includes the following main actions:

1. Adjust Solvency II calibrations to provide a regulatory treatment for insurers that better reflects the true risk of infrastructure investments and provide recognition for investments in European Long-Term Investment Funds;
2. Complete the review of the CRR for banks, making changes on infrastructure calibrations if appropriate;
3. Undertake a comprehensive assessment of EU retail investment markets, including distribution channels and related services, and examine how the policy framework could benefit from new possibilities offered by online services and innovative financial tools (fintech)
4. On SMEs, support venture capital and equity financing;
5. Develop a proposal for pan-European venture capital fund-of-funds and multi-country venture capital funds, supported by the EU budget. This also implies revising EuVECA and EuSEF legislation, and studying tax incentives for venture capital and business angels to foster investment into SMEs and start-ups and promote best practice among Member States;

6. Overcome information barriers to SME investment; Work with European banking federations and business organizations to structure the feedback given by banks declining SME credit applications and information on alternative financing options. This implies working with the Enterprise Europe Network, to map out existing local or national support and advisory capacities across the EU and promote best practices on assisting SMEs which could benefit from alternative funding options;
7. Support, with Member States and prudential supervisors, the development of industry-led business growth funds to support equity in SMEs;
8. Work with Member States and ESMA, to develop a coordinated approach to loan origination and assess the case for a future EU framework;
9. Investigate, building on work done by the ECB, how to develop or support pan-European information systems;
10. Promote innovative forms of corporate financing;
11. Publish a report on recent developments in crowd-funding and, after this, decide on the best means to enable the development of this funding channel;
12. Strengthen access to public markets. Under this item, we include the proposal to modernize the Prospectus Directive, and the review of regulatory barriers to small firms admitted to trading on public markets.
13. Ensure that the regulatory environment for SME Growth Markets is fit for purpose. The Plan envisages also to explore, with the IASB, the possibility to develop voluntary tailor-made accounting solutions, which would be used by companies admitted to trading on SME Growth Markets;
14. Review EU corporate bond markets, focusing on how market liquidity can be improved, and support equity financing. It involves a legislative proposal for a Common Consolidated Corporate Tax Base, including treatment of the debt-equity bias.
15. Revitalising the European securitization market. It implies designing legislation to enable simple, transparent and standardized (STS) securitizations, and revising the capital calibrations for banks and insurers to incorporate the STS criteria.
16. Consult on an EU-wide framework for covered bonds, building on national regimes that work well without disrupting them, and exploring the feasibility of covered bonds for SME loans.

Indeed, this looks a quite ambitious “Action Plan”, which is being implemented between 2015 and 2017.

Is the European financial system on the edge of a Great Transformation?

A critical issue, which is crucial to long-term financing, is the transformation that the European financial system is undergoing. The European Union financial system appears still mostly bank-oriented, as only 1/3 of it is based on capital markets. In the aftermath of the crisis, intervention in support of European banks amounted to EUR 1,600 billion (including public guarantees). Moreover, the banking industry is in the midst of an accelerated process for the application of the most stringent prudential rules under

Basel III. Analogous rules are being introduced for insurance and pension funds, with a consequent tightening in financing investment.

Committed to correcting the excesses of the past, European banks have lowered their capacity to provide medium and long-term loans. At the same time, the crisis has had negative effects on the confidence of borrowers and institutional investors and on their appetite for risk. Credit volumes therefore have contracted in recent years. Signs of difficulties affecting the channels of financing to large companies, SMEs and households have appeared clearly, arousing increasing concern. On the other hand, corporate bond, securitization and risk capital markets in Europe are still relatively underdeveloped, compared with other economies, and non-banking channels are on the whole still relatively inaccessible to SMEs.

The essential question is whether and to what extent it is possible to reduce the heavy dependence on bank intermediation for channeling savings to SMEs and infrastructure, realise a diversification of financing sources with a higher proportion of direct financing coming from capital markets, and mobilize institutional investors and non-banking financial players. The development of non-banking financial markets would also have positive effects on the recovery taking place in the banking channel, because it could free up capital in the banks' balance sheets allowing the granting of new credit. It is necessary to act decisively and swiftly on this front in order to avoid a possible credit crisis, with serious consequences on the entire European economic system.

Evidence indicates that the financing conditions for SMEs in Europe are still constrained. The volume of bank lending has been reduced in the last few years, while in several Member Countries it is still falling. This is partly due to demand sluggishness, but it is also the result of a contraction in the supply of credit by banks due to deleveraging. In addition, interest rates for loans to SMEs are relatively high, and there are significant differences between the various member countries.

Only recently, Europe has taken steps on a number of fronts, where earlier action was needed, such as harmonizing prudential supervision criteria and speeding the cleaning up of bank balance sheets (EBA rules, AQR, Banking Union and Capital Market Union). Unfortunately, the new banking and financial regulations, while useful for preventing new crises and ensuring financial stability, threaten at the same time to discourage investment in the real economy and infrastructure and, more generally, to generate pro-cyclical effects.

In order to foster investment and growth, in September 2014, the European Central Bank (ECB) announced a set of unconventional monetary policy measures (Quantitative Easing or QE) which include, among other things, the purchase of "simple and transparent", as well as of "high quality, mezzanine guaranteed", Asset Backed Securities (ABS).

Securitization is a priority of the Capital Markets Union (CMU). Actually, it is one of its vital components. ABS for SMEs are probably the most needed ones for financing the economy, since SMEs account for 2/3 of new employment and 58% of growth in EU value added. But they are also the most difficult ones to implement. The securitization of mortgages is much easier. We should also consider the securitization of project financ-

ing loans for infrastructure – an essential step for the creation of infrastructure financing as a new “asset class”. This is a key component of the Juncker Plan.

The Commission has carried out a consultation on creating a framework for High Quality Securitization (HQS), which aims at building up an “efficient and resilient” framework for financing, and concrete action is taken to implement the outcomes of the consultation. High quality structures and processes are crucial for the long-term success of this venture. In an environment characterized by very low interest rates, capital retention to risk securitization becomes unattractive. That is why the EU should develop European standards for HQS, and sell it globally.

Covered bonds are already EU regulated. The same should be done for ABS. Calibration remains one of the crucial aspects, and time is of critical importance on this issue. There is currently a broad consensus among experts, regulators and policy makers that, under the current rules, there is no “fair” correlation between capital requirements and the underlying risks of the securitized loans. The regulatory re-calibrations proposed by EBA go in the right direction, but are not enough. The two delegated regulations adopted in 2014 on prudential requirements for insurers (Solvency II) and on liquidity for banks (the Liquidity Cover Ratio) introduced criteria also for securitization. These need now to be complemented and re-calibrated, if we want a EU market for securitization to take off.

Policymakers have been trying to revitalize the market for securitization for several years now. The High Quality Securitizations (HQS) definition for Solvency II seemed to be a first step ahead. However, very little new issuance has been seen. Volumes remain low, especially for SMEs, where we need them most. While revised Solvency II capital charges for HQS only apply to the most senior tranches, they may create distortions with junior tranches and a risk of arbitrage due to the cliff effect.

There are two main problems with ABS SMEs in the EU. The first is the heterogeneity of the underlying products. The second is the availability of credit information. Banks have all the information needed, but this information is not standardized across EU jurisdictions. We need to build a system accessible to all stakeholders. The problem is that information is granular and based on national specificities. We need to work on European platforms of standardized information. Transparency is a major prerequisite. The ECB and the Bank of England requirements for loan-by-loan data as part of their collateral eligibility criteria and the market-led securitization labels, go in the right direction. We still lack homogeneity in risk assessment, in the definition of defaulted assets. This makes it difficult to compare transactions. CMU is an occasion to tackle these crucial issues. Benchmarking different Member Countries is a difficult process. However, today we have the technology for doing it.

Securitization – in the context of the CMU – should be seen as a bridge between bank based and market based financing. SMEs securitization will only become attractive when the recovery grows stronger, and the economy needs new funding. At that time, other sources will materialize. Now the level of capital expenditures appears still quite low. Therefore the urgency is now to put the framework right. We may ask: if funding is so cheap, as it is now, why securitize? Big banks seem to have few incentives. Since

we still lack the basics for a pan-European solution, we should take this opportunity to build the right framework.

Finally, for insurance companies there are still a number of issues to solve before ABS can become sufficiently attractive. Let us list them: an asset class is still not available; a EU market does not exist; if there is no trading there is no liquidity; the market-to-market (Solvency II/Omnibus) is still quite unfriendly to ABS; insurance companies need large teams to evaluate such financial products, especially if there is a lack of standardization; there are still very different loan-to-value interpretations and several definitions of default across European jurisdictions; the cost embedded in the metrics process makes it difficult to construct reliable stress case scenarios; there is high volatility risk, which hinders the validity of the calibration process.

Long-Term financing in Europe: the need to recalibrate prudential and accounting standards

Another issue that is key for long-term investment in Europe – as we already mentioned – is prudential and accounting standards. There is unanimous consensus on the negative effects on long-term investment of the capital and liquidity requirements under Basel III. A recalibration of a prudential and accounting framework, making it more friendly to long-term investment, is needed. However, so far, no concrete results have been foreseen. On the contrary, the Basel Committee is debating a new set of rules (Basel IV), which would make it even harder (in terms of capital absorption and liquidity ratios) to finance investment and the real economy. Moreover, a Report of the Financial Stability Board (March, 2015) is suggesting to revise the zero weighted treatment of sovereign and government-related exposures under the capital and liquidity requirements of banks (the Basel III agreement and CRR/CRD IV), including the large exposures regime, as well as the zero weighted treatment of sovereign and government-related exposures under the solvency rules of insurance undertakings (Solvency II).

The proposed shifts appear unhelpful, and should be avoided. Jacques de Larosi re at the Eurofi Forum in Luxemburg in mid-September 2015 made a bold proposal: to take tough action on CRDIV and Solvency by reducing (at least temporarily) the capital absorption for infrastructure and ABS SMEs. Calling for a sort of “recalibration shock” the French economist and central banker asked policy makers and regulators to concentrate on two of the sectors, which suffer the most in Europe: infrastructure (including social infrastructure) and SMEs. It must be clear that the Juncker Plan and the Capital Markets Union will not take-off, unless significant changes in the prudential and accounting standards are implemented.

The risk – ultimately – is that potential investors in the market for infrastructure and SME financing will have no incentive to participate, even if they wished to do so, due to the effects of existing prudential rules. The latter should be redefined with a better understanding of the requirements for sustainable economic recovery, based on long-term investment. Such rules have become a binding constraint on pursuing both financial stability and sustainable fiscal consolidation. Let us not forget that one of the fields on which global competition is playing its game is the setting of prudential regula-

tions and accounting standards. Tough prudential and accounting regulation penalizing the financing of the real economy and infrastructure has become a major weapon in the global economic and financial contest, which characterizes the XXI Century. It is hitting mostly bank-oriented systems. It needs a “level playing field” to avoid “regulatory arbitrage” and support a non-discriminatory treatment of long-term investment. Financial systems that are more bank-oriented may end up paying a greater price to prudential regulation and accounting standards, than market-based financial systems. We believe that international and national regulators should work together to correct asymmetric regulatory environments.

Enabling infrastructure investment: addressing the interdependencies and the risks

The infrastructure sector faces major challenges. Among them, insufficient investment, partly due to fiscal consolidation, as well as shortcomings caused by poor project selection and planning, inefficient delivery and persistent emphasis on building new capacity rather than using existing assets optimally. With reference to market inefficiencies, there is a lack of suitable project pipelines, inadequate risk-adjusted returns, prudential and regulatory constraints and high development and transaction costs.

Infrastructure needs to be transformed from an “alternative investment” into a real “asset class”. This would enable a significant increase in asset allocations from long-term investors, attracting new streams of investment from around the world. Pension funds, insurance companies, asset managers, foundations, endowment funds and sovereign funds should be eager to invest more in infrastructure. Today they invest on average in Europe less than 1% of their total assets in this sector. In Canada and Australia, by contrast, pension funds and insurance companies invest over 15% of their assets under management in infrastructure.

Governments and public administrations, international regulators and the financial industry have a lot of work to do, to address this hurdle. Development institutions from the G20 countries (the so-called D20) intend to play a growing role in facilitating this process at the national, regional and global level.

Credible and durable solutions have to be found in public private partnerships and other private finance initiatives. Today, globally, these account for only about 10% of total infrastructure financing – while 54% is financed by taxpayers’ money and 36% by corporates. One way to attract global long-term investors into infrastructure financing is to improve the quality, innovation and standardization of projects and financial products alike, including consideration of public private partnerships and the model of impact asset management pursued by entities such as “Finance in Motion”.

Governments have a pivotal and catalytic role to play. Those under fiscal pressure can build on various forms of taxes, user fees and divestures. They may capture property values of land and other real estate to raise funds for new investments or to reduce the price of the infrastructure by providing the land. Governments should also intensify privatization of brownfield assets and utilities to finance new infrastructure developments. They need to increase private and institutional investors’ participation in PPP-like structures by establishing comprehensive policies in this sphere, providing an appropriate

legal and institutional framework. They should increase transparency and provide visibility to project pipelines, establish efficient bidding and procurement mechanisms, and improve risk distribution by providing credit enhancement and/or co-investment mechanisms.

The global financial industry can increase availability of long-term financing through standardized financial documents, agreements and contracts. Methods to facilitate re-financing or resale of mature investments on the books of institutional investors and development banks are also needed.

Establishing infrastructure as a fully-fledged “asset class” will open up funding possibilities to a broader range of investors and pave the way towards innovative financial instruments, capable of bundling and securitizing equity and debt of investment vehicles, having well-defined risk-adjusted returns and customer-focused investment periods.

National and local capital markets have to be developed, giving a boost to capital market instruments (such as project bonds and asset-backed securities for project financing loans). This requires a new relationship, a relationship of complementarity between banks, capital markets and institutional investors. The Juncker plan for investment has in this context an important role to play.

New models and instrument of partnership engaging private sector investors can help in dealing with the current low interest rates environment and providing a predictable (inflation adjusted) cash flow with a low correlation to existing investment returns.

The rationale is that financial markets, the so-called “real economy” and society form a holistic system. Each in turn depends on the other. None of the three is inherently stable, unless the relative interdependencies are managed. In the interplay of the economy, society and financial markets, social infrastructure provides a key catalyst for employment, money and interest. This is why we believe that social infrastructure is a desirable option for long-term investors and an underutilized resource for public and social service providers.

Governments, industry and regulators: the infrastructure challenge

Let us briefly go through some of the major challenges that each of the main players will have to face.

Governments. To increase private and institutional investors’ participation to PPP and PFI for infrastructure, national Governments should do the following: – establish a comprehensive policy, legal and institutional framework for PPP; – increase transparency and provide visibility in project pipelines; – provide lean administrative procedures, cut red tape, regulatory and bureaucratic burdens; – establish efficient bidding and procurement processes; – work on the distribution of risk by providing credit enhancement and/or co-investment mechanisms and instruments; – provide technical assistance to streamline project delivery by shortening time and risks, and defining pathways with clear criteria and time limits; – establish leading practices to protect investors’ rights and their enforceability; – reduce forecasting risk; – provide clauses to mitigate sovereign risk; – mitigate political and regulatory risk. Finally, to increase efficiency it is crucial to

optimize life-cycle cost, meet budgets and enforce competition between bidders to drive price down.

Financial industry and regulators. The global financial system needs in general to increase availability of long-term financing for investment. The Long-Term Investors Club (LTIC) has been lobbying on this since 2009, and it seems finally that the importance of long-term investment is generally recognised. To make long-term investment attractive the financial industry should promote standardized financial documents, agreements and contracts. It should make it easier and faster the re-financing or selling off of mature investment on the book of institutional investors and development banks. Regulators should facilitate the financing of infrastructure by the banking sector removing regulatory disincentives to long-term investments, especially in the construction phase (i.e. capital and liquidity ratios).

The cost of valuating projects for investors must be mitigated – in various ways – but mostly by setting up less risky and more standardized financial instruments. Investors looking for assets to match their risk appetite and future liability, need reliable cash flows and long-term infrastructure projects. Establishing infrastructure as an “asset class” in order to attract a broader range of investors would pave the way to innovative financial instruments, and it would translate in lower transaction costs. The latter appear still too expensive, but can be reduced by standardizing and categorizing risks and their allocations, and especially bundling small and medium PPP projects and project financing loans.

Bank lending still covers around 65% of global project financing. Therefore the supply of loans by banks will remain high in the future. That is why we need to recalibrate regulatory frameworks to make them more long-term investment friendly. Banks, moreover, can play a catalyst role in bringing non-bank long-term private investors into the projects. Reducing the leverage rate may also increase institutional investors’ infrastructure allocations. Finally, to unlock additional institutional investors’ funding, regulators have to lower current barriers such as investment limits on infrastructure and capital adequacy and reserve requirements.

We should recognize that – statistically – infrastructure debt has default and recovery rates lower than corporate bonds, and should therefore imply much lower capital absorption. The aim should be to place this new asset class in institutional investors books between sovereign bonds and corporate bonds. There is, by now, wide consensus that with no recalibration there will be no new “asset class” for infrastructure financing.

Multilateral Development Banks, Regional and National Promotional Institutions. Financial markets are under pressure. The crisis has highlighted huge gaps and correspondingly a great potential. A great transformation is required. In particular, their role in financing the real economy, primarily in terms of long-term, patient, capital investment, has come under close scrutiny. Much needs to be done to fill the gaps and accomplish this essential task. Development or promotional banks are in a strong position to contribute to filling that gap, by fully using their risk absorption capacity and by acting as a broker of developmental/transformational financing. A great opportunity is there

for development banks to reinvent themselves. They have the credibility and capacity to act as intermediaries of financial flows for a number of reasons: their long history (track record); their predictable (non-volatile) behavior; they are known for carefully structuring transactions; they have in-depth local knowledge; they benefit from preferred creditor status and have not been tainted by financial crisis abuses. Moreover, a large majority of them have acquired political weight and delivered significant returns, consistent with risk -and market- expectations.

Moreover, development banks may redress market failures and have a role in stabilising economic cycles. They may also have a subsidiary role in support of commercial banking. They may in fact receive cost-covering margins for on-lending promotional loans provided on nondiscriminatory basis. In so doing, they become, in specific circumstances, complementary to the market, and perform an enabling role in relation to completion. In other terms their prerogatives (tax exemption, public guarantee) do not necessarily distort, but enhance competition.

Among the new instruments, Governments' agencies, Multilateral Development Banks (MDBs) and National Development Banks (NDBs) should reinforce credit enhancement mechanisms, such as monoline mitigation mechanisms, including credit and risk guarantees, first-loss provisions, and the provision of bridge financing via direct loans. Moreover, they may supply special liquidity provisions, if needed.

The key point is that development banks are different from commercial, poly-functional, universal and investment banks. They aim at providing medium and long-term capital for productive investment, often accompanied by technical assistance. The productive investments should be identified, appraised and selected with a two-fold set of criteria: in the short term, they should help make full utilization of production factors (and thus increase employment); and in the medium-term, they provide physical, financial and technical capital, and thus increase total factor productivity. In short, they can be tools of both Keynesian and neo-classical policies.

Development needs development finance, which is a special blend of finance – not just equity or lending (even concessionary lending). Development finance does not mean merely long-term finance, but long-term finance coupled with the capacity to provide technical assistance to the borrower. The capacity to evaluate financial and social returns, to assess the opportunities and the risks inherent in development projects and programs, and to formulate supporting policy measures. Only institutions with such a capacity can, for example, evaluate a program of investment and the associated changes in the tariff regime, fiscal transfers, and regulations. Or appraise a major infrastructure program and address its environmental dimensions. Specialized knowledge comes well integrated with finance.

New instruments and new agencies (MDBs and NDBs) are therefore necessary to mitigate risk and face up to the threat of future credit crunches. They should catalyze institutional investors participation in infrastructure financing, by providing credit enhancement, leaving to institutional investors the senior part of debt, and attracting co-investment in the equity side of the projects.

In Europe, the role of large national and multilateral development banks (EIB, KfW, CDC, CDP, ICO) has become increasingly important. New financial instruments have been designed. Additional resources have been mobilized to support the economy during the crisis, most importantly by financing infrastructure and SMEs, either directly or through the banking system. New European and domestic long-term equity funds have been launched to invest in infrastructure and strengthen company capitalization. Cooperation between these institutions has led to new initiatives and new instruments.

In sum, non-bank financing of infrastructure is probably the most important topic for infrastructure. Therefore the issue – we claim – is the real game changer. It means developing local and global capital markets, and giving a boost to capital market financial instruments (such as Project Bonds and ABS on project financing loans). It means building a new relationship of fruitful interdependence between banks and capital markets – and banks and institutional investors.

The unexplored business within social infrastructure

Financing social infrastructure is one of the most acutely felt problem, and a crucial issue for recovering strong, sustainable and inclusive growth. Globally, there has been, in fact, renewed interest in and understanding of the value of social infrastructure in our economies and societies. In many areas of the world economy, from North America to the Far East, Australia and New Zealand, for example, investment in social infrastructure has been seen as a lever for triggering new business opportunities linked to domestic demand and internal markets. Social infrastructure brings benefits that are essential for economic performance and human development: enhancing the quality of life and the attractiveness of our living environment, stimulating employment growth in services, improving social and human capital, catering for unmet social needs, the protection of the environment and the role of the family.

Social infrastructure has gained the same central role in the urban context given to transport, energy and TLC. Today it represents 13% of infrastructure investment at the global level (B 20, 2015): a proportion that will probably grow very rapidly in the coming decades. The impetuous growth of emerging economies has given rise to a huge growth in urbanization – which means burgeoning demand for social infrastructure. At the same time increasing per-capita income and an aging population in wealthy countries, combined with massive refugee and migrant flows push the demand for high quality and full coverage health, education and other welfare services. In response to major macro-trends, such as climate change, social infrastructure will have to be innovative and creative. Analogously, long-term investment in social infrastructure – relying on the utilization of “patient capital” – will have to be informed *by innovative concepts and designs. Taking into account demographic change, new sources of knowledge, and shifts in societal preferences will require smart listening and efficient delivery. Extending the reach of provisions, safeguarding security of supplies, customizing the production of services vis-à-vis diverse and evolving preoccupations, will represent huge challenges. Last, but not least, the*

*concern with financing, in an uncertain and volatile market environment and ever tighter public budgets, goes to the heart of the social infrastructure conundrum*¹.

Therefore, including social infrastructure among the priorities of the common European investment Agenda – with the same dignity and emphasis of the Trans-European Networks (TENs) – has caught the attention and the support of policy makers. The dream has come about that one-day it will be possible to build with the same policy –and financing- process a school or a kindergarten in Helsinki and in Athens. To make this possible, new and special long-term funds and financial instruments are needed. Some of them are already under study and in some Member Countries have already been implemented. With this goal in mind, we need standardization of projects and procedures. Politically for Europe, a single market of financing and investment in social infrastructure would represent an extraordinary occasion to bridge the world of finance with that of the citizenship. The social underpinnings and implications of the CMU would be made visible and appreciated, as part of a political project for building a “community of peoples”. To illustrate this fundamental perspective, the third part of this Volume is devoted to social infrastructure, its financing requirements, and its growing opportunities.

The way forward

Re-launching investment is the key driver for striking a better balance between sustainable growth and fiscal/balance-sheet consolidation in post-crisis Europe.

Long-term sustainable investment in fact is essential for bridging both visible and emerging gaps in European infrastructure (from Trans-European Networks to the digital divide). Long-term investment is also required for enhancing competitiveness and innovation, particularly in the SME sector. Finally long-term investment is the only way to face up to the long-term challenges confronting our societies: ageing populations, stressed health and social care systems, climate change, environmental degradation, social cohesion and the quality of life.

Risk in long-term investing comes from many sources. Correspondingly, safe investment involves a range of players. Managing such risks and investment requires new parameters and mechanisms capable of shaping the behavior of – and the options available to – the relevant stakeholders, such as institutional investors, regulators, financial intermediaries and capital market players.

After the long and painful crisis we had to endure, we are now at a tipping point with new challenges and opportunities. President Juncker announced that a first priority for the new Commission, and the new European Parliament after the 2014 elections, is to deliver an ambitious Jobs, Growth and Investment Package, capable of mobilizing up to 300 billion euro in additional investment in the real economy over three years. Such a Program will become a success only if policymakers work seriously on creating the right

1 R. Winkel (2008) Innovative concepts for social infrastructure. German Journal of Urban Studies 47(2). www.difu.de/node/6832.

conditions for a stream of bankable projects to be carefully designed and carried out in different contexts sizes and sectors.

A special focus is to be given to social investment, aimed at delivering long lasting social outcomes in communities and markets, providing skills and new opportunities. Equally focus should be put on the PPP concept (Private Public Partnership) or its next step formulation, the P4s (Private Public People Partnerships). If we want to enable long-term institutional investors to support this type of projects, they need to be standardized aggregated and collected in dedicated portfolios. The implied challenges are at the center of the EU and national policy preoccupations and actions in terms of long-term investment, and have by-and-large inspired the contributions included in this Volume, with a view of shedding light on the way forward.

PART I

INVESTING IN LONG-TERM EUROPE.
WHERE DO WE STAND? PROGRESS MADE AND NEXT STEPS

Views from the front-line: the policy thrust

Pier Carlo Padoan

President ECOFIN 2014 and Italian Minister of Economy and Finance

The Juncker investment plan is a timely measure. It has arrived in a context in which the European economy is struggling to grow. Indeed, I would go further by saying that the European economy risks simply bumping along the bottom, with low inflation that risks becoming deflation. It is therefore extremely important that there should be support for investment in Europe, investment being the factor that has been missing for some time, from both the private and public sectors. Investment is a factor that simultaneously sustains both demand and supply, above all in the medium term. It thus reconciles apparently contrasting ideas of the nature of the crisis and the measures that are needed.

I would like to tackle two questions. First, what is needed in order for the Juncker plan to be effective? Second, what should be national policy, in particular that of Italy, in order for countries to use best the Juncker plan?

On the first question, firstly and above all, such a plan must marry good projects with the resources to finance them. The argument about whether more money is needed, or more projects, has dragged on for too long and, as far as I'm concerned, it's a sterile argument. Obviously both are needed. Mechanisms are needed that encourage good projects to be put forward, whether they be from the public or the private sector. This leads me to say that the criteria with which resources will feed the plan must be clear. They must be precisely specified. Naturally this will subsequently be a job for more technical discussion, but it must be implemented precisely. Projects should have a dual aspect. They should be profitable, market-wise, and they should take account of the distribution of resources between the various member-states.

Secondly, it is important to act quickly because the crisis is unceasing, it is not behind us. Many months are required for the Juncker plan to be operational, but already things can be done. The European Investment Bank has a role in this. The EIB and the Commission have led a task force which was set up during the Italian presidency which identified a large package of projects. The face value of these projects is €1,300 billion, probably not all of them financially realisable. But it is important that the work of project selection be started so that this effort does not end with the task force's work but, hopefully, sets in motion more efficient national selection mechanisms. There are opportunities for immediate action. Projects that are considered the most valid can be taken from the project list, available resources such as those held by the EIB can be mobilised, perhaps more aggressively, using this word in a good sense, in terms of risk appetite.

Thirdly, it seems to me that in order for the Juncker plan to yield good results, there must be conditions in Europe such that investment grows and multiplies. This is connected to national measures about which I'll speak later (above all structural reforms) and the single market at a European level. These are measures that by themselves do not translate immediately into investment, but create opportunities for investment. Growth strategy must have investment as a flywheel but must also create an environment favourable to investment that is aimed for both at national and European level. Certainly the internal market is an agenda left half-finished since its beginning two decades ago. A single energy market doesn't exist, neither does a digital market, and so on. It is time that the so-called political capital of European governments switches attention from the challenges of managing the financial crisis and building the banking union to giving renewed stimulus to the internal market.

Fourthly, in order to set the Juncker plan in motion as soon as possible, the mechanism under which member states will put further resources into the Juncker fund is indispensable. Bearing in mind my present role, I don't hesitate to say it is naturally a splendid idea to have a European fund, but almost all member states are working with public sector accounts that are under severe pressure and need clear incentives to transfer funds to a new mechanism. With regard to this, it is important that the Commission clarify soon how transfers to the fund will be accounted for, in terms of the stability pact. This could be done in various ways but it is important that the way it is done should be clear. One could list other conditions under the heading internal market and other structural measures such as the capital markets union, a further integration of financial markets in the whole of the European Union and not only the euro-zone, with the aim of diversifying financial instruments and providing further resources to the Juncker plan.

Up to now I've spoken about what I believe should be done, together with many other things, at European level, and thus the responsibility of European institutions. Additionally, there is an implicit agenda for each member state to follow in order to benefit fully from the Juncker plan and its offer of more resources for investment.

I will now address the second of the two questions which I posed when I began. What should be national policy, particularly that of Italy?

First, our new agenda of structural reforms is fundamental for increasing the opportunities for investment. Structural reforms by themselves change how markets function, and thus open up opportunities that previously did not exist, and give rise to potential new investment projects to exploit those opportunities. From this stems the need to accelerate the agenda for structural reform, particularly in a country like Italy where the structural obstacles to investment have been increasing for more or less twenty years. The Italian crisis does not therefore only reflect the deep recession of recent years but also the more distant problem of structural obstacles to investment.

A second aspect concerns fiscal consolidation which, clearly for a highly indebted country, is fundamental and must be reaffirmed in order to maintain market confidence. Additionally, the process of consolidation must take account not only of the size of big aggregates, and of how the deficit and debt are changing, but also of the quality of any adjustment. How are tax revenues used? Are they used to support investment, and can

thus be complementary to the Juncker project, or not? Is it possible to change the tax structure, keeping tax revenues the same, in order to support investment? The answer is yes. Where there is the opportunity of higher investment, I believe that the structure of the budget may be altered, obviously within the constraints of on-going consolidation.

A third issue concerns Italian capital markets, As you are aware, the job of financing the economic system has been in large part fallen to banks and banks must obviously continue to do their part. However, this is the moment to diversify financial instruments, using measures that encourage the entry into the market of non-bank players like long-term investors, and to encourage firms to turn to alternative, new financial instruments such as mini-bonds. Such things widen the portfolio of instruments available and allow a link between private investment decisions and an investment decision that has a public-sector origin, as the Juncker plan indicates.

Finally, last but not least, there is the matter of national promotion banks. I believe that they can, indeed are, able to provide a fundamental contribution in this new context either by their own initiatives, or by supporting and reinforcing the projects to which the Juncker plan gives birth.

All these things together create, and of this I'm fully convinced, a very different climate, and they will begin to produce results very soon. There is a further, perhaps intangible, advantage. It is quantitatively less easily identified but, I consider, extremely important from a qualitative point of view. Insofar as it is possible to carry forward a programme of support for investment to boost growth, using instruments such as those I've mentioned, this will have an impact on expectations. This is because markets and firms on whom the burden of investment falls will recognise a positive political signal, both European and national. This will be an extra, very important ingredient for encouraging investment because it will give a sense of working for the long-term. After all, the Juncker plan is officially called the long-term investment plan.

And this is the subject of this conference. An essential element for the long-term to prevail is precisely to believe that results will be positive in the long-term. Policy has today, more than ever before, the responsibility of offering a long-term prospective and to focus on the use of resources that may be there but that are not used because confidence is lacking.

Martin Schulz
President of the European Parliament

Investment will be the key word which defines the coming years and for this reason all tools enabling this deserve the highest political support. Rest assured that I am fully behind your conference's core initiative of driving long-term investment higher up on the policy agenda.

The dramatically large investment gap in the EU as a result of the crisis requires all actors to work on all available fronts to get investment going again. If we cannot then all the efforts being done to reduce our debt burdens and reform our economies will be for nothing. I am pleased that EU legislators are not sitting on their hands. Just some days ago European Parliament negotiators and the Italian Presidency reached an agreement on legislation to enable European Long-Term Investment Funds.

In the coming days the European Parliament will ratify this deal during its plenary sitting. These funds have the potential to be an important component of a wider strategy to stimulate investment in the EU. They will greatly improve the ability for savings in one EU country to be constructively invested in another thus reducing an obstacle which proves very problematic for a wholesale recovery of the EU economies. These funds will be dedicated exclusively to financing long-term projects, exactly the ones the EU needs so badly. Much still lies ahead of us but the good news is that we have some clear, tangible goals to aim for.

First of all we must urgently ensure that the European Fund for Strategic Investments is set up in the best way and that all actors shoulder their responsibilities to develop projects which are attractive to private investors. Another key goal will be the successful establishment of a capital markets union. President Juncker's investment plan can certainly provide a helping hand to large projects. But there countless investment opportunities which go missing and unheard on a daily basis and which could benefit greatly from a union where capital could move more freely. A capital markets union can reduce the obstacles for even the small SME to obtain the finance it may need to develop its great idea.

This is just a broad brushstroke look at what we need to be doing and where we need to be going over the coming years.

Rintaro Tamaki
Deputy Secretary General OECD

Before presenting the OECD's latest work in this area, and our high-level contributions to the G20, let me take a moment to explain why long-term investment is so fundamental to the pursuit of stronger, greener, fairer growth.

Long-Term Investment: What's the problem?

It is now six years after the Global Financial Crisis, and yet a robust recovery still seems distant; global growth is uneven and halting; unemployment is stubbornly high in some regions.

Here in Europe, low growth forecasts and the spectre of deflation cast a long shadow, while new global risks gather on the horizon: the build-up of debt in emerging economies, the return to bullish risk-taking in global financial markets, and rising geopolitical tensions in Eastern Europe and the Middle East.

Responsible macroeconomics, accommodative monetary policies, and fiscal consolidation have all borne important fruit, but there are now fewer arrows left in the quiver of Keynesian economic policy to stimulate growth.

Now it is time to focus on a strong recovery.

What is perhaps the brightest spot for the future is investment: a light that has the potential to guide the Eurozone back to prosperity.

The enabling environment for long-term investment requires improvement, as investor confidence may be hampered even when necessary financing is available.

The OECD's FDI Regulatory Restrictiveness Index indicates for instance that ownership restrictions on foreign investment in utility sectors such as energy and transport, which are particularly well suited to long-term investment, remain high in most OECD countries.

More could also be done to level the playing field between state-owned enterprises and private investors in terms of their ability to seize investment opportunities.

Ongoing delays and uncertainty surrounding the international trade and investment agenda may be impeding investment as well.

Mega treaties such as the Transatlantic Trade and Investment Partnership (TTIP) could enhance trade and investment liberalisation, but current criticisms on Investor State Dispute Settlement are delaying the conclusion of the agreement, adding more uncertainty to an already volatile environment.

We consider investment to be the very backbone of the economy, and a critical ingredient for growth – infrastructure is a prime example.

Yet global flows of foreign direct investment remain 40% below their pre-crisis levels.

The impact of smart investment goes beyond the economy.

Investing in infrastructure, especially social infrastructure, can connect communities, helping strengthen society and the sense that the economic system works for people.

The announcement of the Juncker Plan, which we will certainly hear more about today, is the type of initiative that is needed to breathe life into the Eurozone economy and to improve competitiveness.

Mobilizing private capital, the subject of today's conference, can lay the foundations for Europe's future, while creating thousands of jobs in the near-term.

Furthermore, promoting an agenda of green investment can underpin the needed transition to lower-carbon economies.

So, the returns are not only financial, but economic, social and environmental also!

Ultimately, we need to see a 'comeback' in both domestic and cross-border long-term investment if we are to see a sustained and durable recovery.

Let me share with you some of our views, and some of our recent work with the G20 on Long-Term Investment.

LTI: What's the solution, and what are the G20 / OECD doing to help?

The G20's Brisbane Action Plan just launched a few weeks ago stresses the need to mobilise long-term investment by institutional investors, who have over USD 92 trillion in assets under management in the OECD alone.

This amounts to a staggering 2.0 times the size of the OECD economy, up from 1.4 times 12 years ago.

Put another way, institutional savings have never been higher.

The Brisbane Action Plan also recognises that improving the domestic investment climate is "essential to attract new private sector finance for investment", highlighting the urgent need to address impediments to investment, such as FDI restrictions and market access barriers.

Despite the large growth in institutional investor assets, there are numerous barriers to long-term investment.

Based on a recent OECD survey of large pension funds, you will hear more about it today, regulatory uncertainty is a top concern.

But, they also have to negotiate an often difficult or unpredictable business climate; a lack of profitable and "bankable" projects or appropriate financial vehicles; and an information gap: matching investments with investors that align the interests of both parties.

Last year, G20 Leaders last year endorsed the OECD High-Level Principles on Long-Term Investment Financing by Institutional Investors, developed by a dedicated G20/OECD Task Force.

These High-Level Principles set out policy recommendations aiming to mobilise institutional investor assets for long-term investment without diluting prudential safeguards.

This year, the OECD has moved hand in hand with the G20 economies "from solutions to actions" to operationalise the High-Level Principles developing Effective

Approaches to the Principles, and a voluntary checklist to assist governments in self-assessing their support schemes for long-term investment finance.

This work to continue in 2015 is supporting the new Global Infrastructure Hub, launched at the G20's Brisbane Summit.

LTI: What are the next steps?

Going forward, the OECD will prioritise policy efforts to support capital market development as a means of unlocking pools of alternative, non-bank sources of finance for long-term investment. We shouldn't lose sight, however, of the still important role of banks in financing growth. Traditional sources of credit are still repairing their balance sheets after the financial crisis, while more stringent lending standards can also constrain credit, particularly for SMEs.

We need to get the balance right!

Next year, the OECD will work with the Turkish G20 presidency both to deepen and broaden the analysis on LTI financing.

This work will include a comprehensive taxonomy for infrastructure financing that covers the wide range of both financing options and risk mitigation methods.

The OECD also stands ready to work with the G20 Turkish Presidency on developing indicators on the enabling environment for long-term investment.

This can build on the critical mass of country experiences that the OECD has gathered in applying its Policy Framework for Investment since 2007, to be presented to you tomorrow.

On infrastructure investment in particular, this wealth of experience has led the G20 to request the OECD to elaborate, together with MDBs, indicators to help countries further mobilise infrastructure investment through domestic policy reform.

In Brisbane, the G20 leaders were also clear in calling for better networks for sharing ideas.

To this end, the OECD continues to work closely with the private sector, notably with institutional investors, and has just launched a large and growing Network of Investors including the Club of LTI and Cassa Depositi and Prestiti as part of the OECD Long-Term Investment project.

If we are to turn High Level Principles into tangible results, we need to forge a close partnership with the institutional investor community while advancing the long-term investment agenda with governments.

Jonathan Hill
*Commissioner for Financial Stability,
Financial Services and Capital Markets Union*

Near where I live, outside the cathedral city of Salisbury, there is a long, straight road, cutting straight as an arrow through the English countryside. As I drive along – I almost said speed along it because it is so straight – I sometimes think of the centurions who tramped its length, and the traders who followed them. Roman infrastructure was built to last. An early example of long-term investment in Europe that is still benefiting people nearly twenty centuries later.

My ambition today is more modest than the Romans—how could it not be?—but I want to speak about how we can get investment flowing again in Europe, bringing in its wake the jobs and growth we need.

This conference is one of the last events to take place under the auspices of the Italian Presidency, so on behalf of the Commission, I would like to express my congratulations and thanks to Piercarlo Padoan. Thanks to his efforts – and those of Roberto Gualtieri – we have made progress in a number of areas. We have brought negotiations on European Long-Term Investment Funds to a successful conclusion. And earlier this week we put in place another building block of the Banking Union relating to the contributions to the Resolution Fund. So thank you for the efforts that you have put into these sometimes difficult negotiations, and congratulations to Italy for running a successful Presidency.

Let me start by giving you a sense of the new European Commission. We want to be a political Commission, and to pursue a clear set of priorities. President Juncker wants the Commission to be big on the big things, and small on the small things, and I couldn't agree more. We are driven by a sense of urgency, which itself stems from the scale of the challenges we face. President Juncker has talked of the EU being in the last chance saloon. As I see it, the EU faces two great challenges: the democratic and the economic. In last May's elections, the proportion of citizens who voted fell in 18 out of 28 of our Member States.

The economic challenge is also pressing: competitiveness has declined in various parts of the Union, 12% of its workers are unemployed, and a truly shocking 40% of Italian young people are unable to find jobs. So delivering on our commitment to jobs and growth is not only vital for individual companies and workers. It is also essential to rebuild trust both here in Italy and in the EU as a whole.

This explains why President Juncker has set a fast pace. The new Commission is only five weeks old, but we have already launched our Investment Plan and are about to agree our Work Programme for 2015. This will show how we are going to focus our efforts and concentrate on our top political priorities for the European Union and the European

citizen. Of these, one stands out above all the others: jobs and growth and that brings me to the 315 billion euro Investment Plan.

It is built on three elements. The first of these is the new European Fund for Strategic Investments. Its job will be to mobilise investment finance without creating new public debt. We know there is no shortage of private funding but that money is not making its way to the rest of the economy. So the purpose of the fund is to take away some of the risk of investing in long-term projects and thereby encourage private investors

Kick-started with 21 billion euros of funding, we believe that it should be possible to leverage in private sector investment on a scale that takes the value of the Fund to 315 billion euros, thanks to the credit protection offered by the Fund via the EIB. That leverage ratio, by the way, is less than the 1:18 ratio that the EIB's 2013 capital increase achieved and the 1:20 ratio delivered by the Loan Guarantee Facility for SMEs under the COSME programme.

But for the investment to flow, it will need to be supported by the second leg of the plan: a credible project pipeline, backed by technical assistance, to link investment with mature, growth-generating projects in key areas like energy, telecoms, transport, services and research. Things like rolling out broadband to help support small businesses in rural areas. Improving energy networks in areas that suffer supply shortages or creating transport infrastructure to get people and goods to where they are needed most.

The selection of the projects to be funded cannot become a political football in each Member State for the inclusion of pet projects. The criteria of added value and viability will have to be applied rigorously. This should work in Italy's favour, with your important SME sector and your strong history of manufacturing excellence. The fundamentals are there. The Investment Plan will provide an opportunity to remove barriers to investment and growth in Italy and to spur the recovery that it needs so much.

The third leg is to remove red tape, regulatory bottlenecks and other barriers to investment. This could have the greatest long-term benefit for the European economy. It will mean removing barriers to entry to certain sectors and making the single market work better. Our service companies, our professions, our digital sector, our investors, inventors and creators all need the one thing we have promised them for decades: a genuine single market of hundreds of millions of people in which they can offer their talent, their goods, and services, their ideas and their inventions. And beyond our borders we can offer new trading opportunities, for example in the USA once we get TTIP properly explained and fully in place. Jobs and growth will come from the single market and trade, not from politicians. Our job is to provide the right conditions for the economy to get moving again.

So how will I, as Commissioner for financial stability, financial services and capital markets union, support those priorities? First, I will be looking at everything I do through the prism of jobs and growth.

The past few years have seen a great swathe of new rules being introduced to govern the financial sector. These were essential to respond to the financial crisis and to help restore financial stability. And financial stability is the first part of my job title. But right

now, we face another threat to financial stability: a lack of growth. There is no growth without financial stability, but there is no financial stability without growth.

Looking ahead, I do not anticipate that we will need anything like the same volume of new rules in future. Some people are urging me to have a bonfire of existing legislation. To them I say that there can be no going back. But I do want to look at the cumulative effects of the legislation we have passed. And I do not think we should be afraid to look at regulation again if we find that we have not always got the balance right.

One of the key tasks I have been given is to help build a capital markets union so that money can flow through the EU to where it can be most productive. I see this as a classic Single Market project – a project for all 28 Member States.

My ambition is to help unlock the capital around Europe that is currently frozen and put it to work in support of Europe's businesses, particularly SMEs.

A couple of figures make the point. We in Europe save lots of money – 2.7 trillion euros worth, one third more than in the US. But mid-sized companies in the US have roughly five times as much funding from capital markets as their counterparts in the EU. EU businesses get about 80% of their financing from banks, and 20% from debt securities. In the US, depending on which set of statistics you are reading, or which statisticians you are talking to, the ratios are broadly speaking the other way round.

At the moment, small business owners here in Italy who want to expand their business are likely to turn to friends and family or the local bank. I want them to have the confidence to explore other options and to have better access to capital markets. This could be achieved through worthwhile private initiatives: the so called ELITE project of the London Stock Exchange/Borsa Italiana group is one such example.

But there are others. Perhaps the Italian small business owner could list his business on an SME growth market, giving access to investors anywhere within the EU? Why should he/she not think of attracting professional investors like venture capitalists or private equity funds?

More than fifty years after the Treaty of Rome, we still don't have free movement of capital. Shareholders and buyers of corporate debt rarely go beyond their national borders when they invest. Savings are essentially compartmentalised in Member States, and are too concentrated in the banking system. This is holding back the size and depth of capital markets, making it difficult for investors to diversify.

There are a number of obvious reasons for this fragmentation.

There are differing rules, documentation and market practices for products like securitised instruments and private placements.

There is the tax element, with a bias in favour of both corporate debt and mortgage debt. The national nature of insolvency law. And investors don't have access to comparable information on smaller businesses to assess the risk of investing across countries.

But there may be other issues that we need to unpick. That is why I will be launching a broad public consultation early in the New Year. I want to approach this challenge from the bottom up. Identifying problems, sector by sector and country by country, and then working out how we could remedy them.

I will listen to everyone who wants to contribute – parliamentarians, Member States, individuals, consumer groups, and of course the financial sector and its customers. Above all, I want to hear opinions from all 28 Member States because this must be a project for all 28. Once we have had this input, we will come forward with an action plan in the middle of next year.

But we can already see some early priorities for action: a good example is the development of European Long-Term Investment Funds. These are designed for investors willing to put their money behind projects and companies that need long-term finance. Until now, those projects might not have been able to raise money on the stock markets or get lending from the bank. Now they will have a new option. ELTIFs should make it possible to increase the funding available for infrastructure, other long-term projects, and for SMEs across the EU.

They should be particularly attractive to investors such as insurance companies and pension funds that need stable, steady income streams or long-term capital growth. But perhaps they could trigger a whole culture change and become the go-to instrument for long-term, stable debt encouraging long-term investment in other categories of investor too. Once again, my congratulations and thanks to both Roberto Gualtieri and the European Parliament, as well of course to the Italian Presidency.

Another area of work that is developing fast is that of high-quality securitisation. Simple, transparent and sound securitisation instruments, where issuers retain part of the risk and investors know what they are investing in, could help improve financing conditions.

Securitisation markets have fallen sharply since their pre-crisis peak, with issuance of simple ABS products in 2013 reaching less than half of the 2007 level. If these markets were revived – safely – with high quality securitisations to take us only halfway back to the pre – crisis peak, this could be equivalent to between €30 and €70bn of additional funding and free up bank balance sheets for lending. Although I don't want to oversell its benefits as some sort of silver bullet, it could help form a bridge between banks and capital markets, allow banks to trim their balance sheets and free up capital for lending. And it could help offer investors good products with reasonable yields. But if securitised instruments are going to be trusted, we have to specify clear criteria and levels of transparency, and frame the new system in a way that is sound and understandable for investors.

The Commission has recently adopted specific rules that apply to the insurance and the banking sectors to help promote high quality securitisation. These are the first steps towards a wider EU framework that I want to develop, building on work already underway in the EU such as in the European Central Bank and Bank of England as well as globally.

And we are exploring a number of other avenues to getting the Capital Markets Union going, from looking at how we treat covered bonds in our legislation to examining how our private placement markets compare against their international peers.

If we could increase annual issuance via private placement markets in Europe by just half, that would be equivalent to about \$5-10bn of additional financing opportunities a

year. I will bring forward a review of the Prospectus Directive with a view to lifting unnecessary administrative burdens on companies that want to raise capital across the EU.

And longer term, I want to think of ways to give greater access to SME credit information to encourage investment from a wider pool of investors.

Creating the Capital Markets Union will be a multi-disciplinary, cross-sectoral project; one that will need support of everyone from institutional investors to small businesses and from legislators to banks. I believe it will be an essential building block in getting Europe back to work. So I hope I can rely on your support.

I also want to take a serious look at retail issues. In recent years, on the back of the financial crisis, the Commission focused on the wholesale, systemic side. Now it I think it is a good time to turn the telescope around and look at financial services from the perspective of the consumer and retail investor. I will be meeting a group of consumer representatives today and will listen to what, concretely, they expect from a well-regulated financial sector. We must work untiringly to create a single market for small companies and individual consumers.

The Capital Markets Union is one example of how the financial sector can act as part of the economic mainstream; supporting companies and encouraging growth. Financial services must be the oil in the economic machine. And financial services firms should adhere to same high standards we expect of ourselves. This is not the same as mere compliance with rules.

The culture of how a business behaves is what is most important, not a box-ticking mentality. If, together, we can achieve that; can build a new culture of compliance with the spirit as well as the letter of the law, then I will be the champion of that well-regulated financial services industry and will defend the contribution it makes to growth and jobs.

Ladies and gentlemen, the scale of the economic damage that Europe suffered in the crisis is daunting. So we must now focus on delivering real change. As well as being taught about Roman roads and baths at school, English people of my age also learned that Rome was not built in a day. Constructing the right framework for long-term investment will not be done in a day either. But I am confident that in the years ahead we can put down some strong foundations. And by we, I mean Member States and businesses as well as the EU.

Strong, lasting growth is the key to getting people back to work and improving living standards. These outcomes are what the public will judge us on, whether we are policy makers, lenders or investors. We need to create the right business environment in which growth can take hold. Get money back to work to support the companies and households that need it. And fund much-needed infrastructure that will make it easier to do business across the EU.

So that perhaps, generations from now, people here in Rome and across Europe will look back and think: after some difficult times, they refocused on the priorities, they made the right policy choices to restore economic growth and jobs; they got it right.

Pierre Moscovici
Commissioner for Economic and Financial Affairs, Taxation and Customs

How to make long-term investment in Europe happen in concrete terms, on the ground.

Investment is a series of individual micro economic decisions which are the pulsing blood of an economy. Taken together, and accumulated over time, these decisions produce, and constantly regenerate, the backbone of our economies. I would like today to share some thoughts on this macro-economic side of investment.

As European Commissioner for Economic and Financial Affairs – the macroeconomic context in which investment happens, or does not happen, is one of my main priorities. And I believe European authorities, together with Member states, can have a large influence on this context. Let me tell you how.

Today, the European economy is reaching a very decisive point. We experienced five, six years of zero average growth since the beginning of the crisis. Recovery is underway, but we know it is very fragile and vulnerable to external shock. In 2017, the crisis will already be a decade old. We therefore cannot afford to run the risk of a triple dip which would open the way for secular stagnation with low growth, low inflation and high unemployment and inequalities slowly killing future growth.

My view of economic policy making at the current juncture is that we have to think in terms of risk management and security margins. We therefore cannot count on spontaneous recovery – waiting idle will, at best, bring disappointingly low growth. At the same time, we should not risk reversing one of the main achievements of the past couple of years: the stabilization of the Eurozone and through credible fiscal and financial consolidation in a context of very high public and private debt almost everywhere in Europe.

Our challenge is therefore to kick-start economic growth in Europe again, without reversing financial stabilization. In this context, let me underline two elements, which to me constitute the starting point we have to build on in the near future.

The first element is the comprehensive assessment of the European banking system by the European Central Bank. With the Banking Union now fully functional, and clarity on the situation of the banking system in Europe – the European economy can rely on a sound financial system to grow again.

The second element is the now neutral fiscal stance in Europe and in the Euro area as a whole. The Commission, and the Eurogroup, have taken stock of the fact that the stance had become neutral. It is welcome at this stage, as an appropriate balance between sustainability requirements and current weak cyclical conditions.

These two elements, together with the current economic situation, embody to me the fact that we are entering in 2015 a new economic sequence. In this new sequence growth is possible again investment will be key.

Everybody now knows that Europe is suffering from a large investment gap, an accumulated shortage of investment for many years now. This gap is at the same time the consequence of past low growth, and a possible cause of future low growth. Action is needed to break that vicious circle.

The size of this gap is hard to assess. One thing is for sure: it is large certainly many hundred billion euros, maybe a trillion or more.

Interestingly, this gap is the result of a long multiannual process of underinvestment and yet it became common knowledge in just a couple of months since last spring!

As a member of the French Parliament I had the occasion before the summer to work on the assessment of this gap, and on possible ways to close it. Let me share some of my conclusions, which are, as it happens, very much in line with what the Commission is now putting in place...

Addressing this investment gap is at the same time fighting against lack of aggregate demand in the short run, and preparing higher supply capacities and potential growth in the medium to long-term. Working to fill this gap is therefore good policy both short and long-term. This is welcome given the high heterogeneity of economic conditions in the Eurozone today: some countries clearly face first demand problems, other structural, supply side challenges, and many, both at the same time.

A successful strategy for investment in Europe should in my view follow some simple principles:

- It should target additional projects,
- It should be timely, (I will come back on that)
- It should be focused – you discussed today the main and well known areas where long-term investment for the future makes senses: networks and social infrastructure.
- It should rely on private money when possible and public money when necessary and aim at crowding in, not out private funds (I will come back on that too).

The Investment Plan for Europe constitutes a determined and decisive answer to these challenges. There is a triangle for investment with three key pillars:

- Mobilising finance – using EU level instruments in a new and smarter way to boost strategic investment through the creation of EFSI that will bring confidence by taking risk out of the equation and help risky project find private financing.
- Making finance reach the real economy – through a stronger, more transparent pipeline of projects, supported by technical assistance.
- Improving the investment environment – by removing non-financial regulatory barriers in our single market.
- The backbone of our Investment Plan is to make smarter use of the money we have.

As I said before: more debt cannot be the solution.

Together with €5bn from the EIB's own resources this will constitute a €21bn «European Fund for Strategic Investments». So, with the backing from the Fund, the EIB will

be able to provide financing for projects that have a high return for the EU economy but would have been too risky for private investors to consider. The European Investment Fund will provide equity directly to SMEs which will find it easier to obtain market funding. This way, we are confident that we can progressively mobilise up to €315bn of financing additional financing for strategic growth-promoting projects.

But financing is only one, even if important, part of the story. In fact, we often hear that the issue is not a lack of financing but a lack of projects. Let's not forget that financing is not the only issue though. Many existing funds private or public, are not used- or not used in Europe, because the pipeline for good projects is not that full.

It's important to promote an environment more conducive to profitable projects. This imply action at the micro level (complete the single market) and at the macro level (avoid long period of very slow growth).

We intend to create a real one-stop investment hub at the EIB for all stakeholders of the investment financing process: public authorities that wish to make use of innovative financial instruments, potential investors, potential investees. This way, we will make relevant information and know-how more visible and accessible for those that need to have it.

There is an obvious need for further structural reform, including on the Union level. Further integration of the Single Market needs to take place, especially in transport, energy and knowledge industries; and the Commission will continue to work on this.

Now in any such ambitious endeavour, the devil lies in the details. And I know there has been some scepticism out there.

The first priority now is to get the legal framework ready as quickly as possible. We will work with the Member states in the Council, to provide investors as quickly as possible with clarity about the tools. Our goal should be January 2015. I am confident we will succeed.

Criticisms have been voiced that public money was not sufficient in the overall framework. Let me give you my personal appreciation: we at the European level have done our job in designing an ambitious and fully functional financing tool.

Obviously Member states can decide to chip-in with national contributions, to send a strong signal. I do think that it would certainly enhance our firepower, in particular in areas where private financing may not suffice, even when strongly enhanced through guarantees.

This is specifically the case I think in the case of a very important field of investment for the future: human capital, research, education and training.

The Commission's role can be to help Member states coordinate by providing clarity on the treatment of national contributions (in the stability and growth pact, in the governance) – we are working on it.

The Investment Plan for Europe should not be considered as a static construct. It is a flexible tool which we will pragmatically adapt if needed in the course of the coming months and years. Our only metric for success will be the number of good investment project emerging in the Member states.

So we will monitor very closely the possible shortcomings of the plan in its first months and address them in a timely way if necessary. The constant and constructive feedback of investors and the Member states will be key in this regard.

Before I conclude let me share what I view as the main risks to success are:

We also have to be conscious that the issue of the timing is key, both for macroeconomic and for political reasons: we need results in 2015 – we cannot afford to wait until 2017 to see the first signs of success on the ground! Expectations are high – beware of a possible political kickback if no concrete signs can be seen soon.

We have also to be very cautious and avoid two dangers in terms of governance and selection of the projects:

Risk aversion which would lead to invest in the places and projects which would have taken place anyway; the Investment Plan for Europe is a new tool for a new purpose: taking more risk to invest in the future of our economies, at a point where, obviously, this does not seem to be an obvious call. We should make no mistake: no risk means no returns.

Last we European policymakers should refrain from the temptation of «juste retour», where each Member state expects to quickly get back what it paid in. Not only is it contrary to the European spirit, but it would be very short sighted at the current juncture as it would ignore how interdependent our economies have become.

The economy of the continent faces the risk of a long period of disappointingly low growth if we fail to succeed in closing the investment gap.

We collectively made huge progress in the last months in recognizing the risks, and putting in place a clear and flexible framework to take on this challenge.

Policymakers, market participants, and entrepreneurs everywhere on the continent should now work together to make the best use of the tools. Constant discussion between stakeholders will be key in the times to come. Let's get to work, let's make it work.

Michel Sapin
French Minister of Finance

The subject deals with important topical issues. I would even say it is urgent. Not only because of the Juncker Plan – I'll get back to that – and not only because the European Commission is planning to take some welcome initiatives, but because (I mentioned the European Commission as this is the time the Commission gets involved – just to show how this functions well so not only because the European Commission is acting – and it will tell us why it is making such a proposal – but also because addressing the problem of lack of investment in Europe, particularly long-term investment, will also address the problem of reduced future capacity for growth on our continent compared to the other great continents of the world.

All of us know... it has already been said and I will repeat certain things Pier Carlo Padoan has already said (which shows we think alike on many issues)... we all recognise the difference between funding levels before and after the financial crisis. I said both public and private funding – some EU countries were able to maintain public funding levels but experienced a decline in private funding while others experienced a decline in both private and public funding which explains for a large part the difficulties Europe is having.

The second thing is that we need to adjust our economic and monetary policies to the current environment of very low growth and very low inflation (the term “low inflation” is no longer accurate as it is now below zero) and, in many EU countries including Italy and France and others, to very high unemployment. Monetary policy has been adjusted by the European Central Bank – I won't comment on that here – we can see that the ECB can still act – but to take a term used by Mario Draghi – monetary policy will not solve the problem alone.

Other tools required for a balanced and efficient policy must also be adopted both at the national and eurozone level. These are obviously the budgetary pillar and structural reforms.

Regarding structural reforms – each country must institute necessary reforms based on their economic and social circumstances and internal organisation. That is what Italy and France and other countries have done. Saying it is not enough – it has to be done.

But there is also budgetary policy. Budgetary policy is not an unchangeable giant which cannot adapt and evolve. While we are not in a situation today that requires overturning the budget – what I mean is that it is not like in 2008-2009 when we all needed to immediately adopt a stimulus package – that would be unsuitable, even harmful to the balance of our monetary zone. But we do need to adapt our deficit cuts or debt reduction targets (by looking at different countries of different nature where problems are

manifested in a different manner) to the economic reality. And what the Commission has opened up for debate is to analyse the global fiscal position of all eurozone countries and the effect of these juxtaposed budgetary policies on the eurozone is a good way to look at things in order to then draw consequences country by country according to the circumstances in each country.

There must therefore be a less restrictive budgetary policy that – if I am being positive- stimulates the economy more than it has. But as it is not just anyhow, as it is not just by stimulating consumption which we know would have little effect today – investment is of course the right tool as it satisfies immediate demand and supports economic activity while working hand-in-hand with structural reforms and structural investments and it is related to- even if it is not immediately obvious- with structural reforms.

The point is that our economies have a deep capacity to yield growth, jobs and fix our problems which is why it is absolutely necessary to maintain investment capabilities in each of our countries regardless of the pace of deficit reduction and why it is absolutely necessary... to support some initiatives like the Juncker plan so we can implement investment programs suitable to our circumstances as well as to our personal situations in the most relevant and in the fastest manner.

Inevitably, we must always try to avoid clichés like the one that there are those who support public investment and those who support private funding. No. I would describe the situation in Europe – there is less public investment in Europe today than in 2007 but there is even less private investment today than in 2007. It must therefore be ensured that the whole of it recovers to a level... a level that satisfies the needs of our society and our economy. That is above all private investment but we all know if that is all that was needed, projects would already be funded – we know that we need to choose the right projects and at the same time we need something more -considerably more – public investment or state guarantees so that a project that has not yet been funded because it is not fundable becomes fundable because it becomes profitable and accessible to the relevant private investment. We have to identify and encourage this balance – it is not only Germany that only wants private investment or France, to take one example, that wants public investment – we have to combine the two to promote efficiency and allow all investment capacities to find outlets, to find projects, to implement projects that become profitable taking into consideration the ongoing public initiative- that is what the global balance of investment policy is at both the national level and within the Juncker framework.

There are also questions – I think you discussed this with Lord Hill – about relevant regulations on risk prevention and market risk capacity. These questions also relate to the development of high-quality securitisation which allows our banking system to find new investment opportunities. So they are also regulatory issues.

Finally, I would like to address the most important issue – the urgency. If we don't act quickly this extremely toxic situation – I wouldn't call it a crisis but rather a situation – is a situation that can last and have social and economic consequences for those countries which have experienced very weak growth and inflation for far too long. Those consequences can almost be as harmful as a deep crisis where we sometimes feel we can

escape or bounce back from. There is therefore a real risk. The risk has been identified. Urgent action is needed. Urgent action. Proposals must be refined and project choice terms and financing methods must be quickly specified, including at the European level.

I often say that we are not asking that the 300 billion – the 315 billion in the Juncker Plan was spent in 2015 but we must not wait until 2017 for the 300 billion to be spent and implemented. It is urgent that we ensure that some of the investment capacities find outlets by 2015 so that our countries can slowly find a path to growth by both actual investments and by improved investor, economic and market expectations that return momentum to growth and confidence.

Views from the front-line: new industrial perspectives

Relaunching Long-Term investment and financing in Europe

Italian Banking Insurance and Finance Federation

1. From investment-less stagnation to an investment-driven recovery

The EU must go back to sustainable and inclusive growth as quickly as possible: this requires long-term investments and corresponding finance. Between 2007 and 2013 public and private investment declined in real terms by one-fifth in the Euro-area. This has sapped growth and growth potential, reduced international competitiveness, created significant unemployment notably among the young. Not only physical but also human capital has been, and is, adversely affected.

Difficulties in the Euro-area are especially acute in stressed peripheral countries but reflect also weaknesses in the core. The capability of reforms to re-launch economic growth is being undermined: as the Italian Minister of Economy and Finance put it: “the time for action on investment and structural reforms is now”.

Economic recovery, rebalancing of structural misalignments and sustainable growth need to be investment driven. Capital formation leads to innovation and enhances competitiveness; it represents a crucial link between demand, supply and productivity.

Fiscal consolidation should not result in severe cuts to public investment in effective and efficient infrastructure projects, in green energy, TLC, R&D and support measures for SME investment. Large and small good infrastructure projects deliver benefits with important externalities. Public and private partnerships and co-financing schemes must be actively supported; it is however evident that all the advantages of infrastructure outlays cannot be fully captured privately.

Given the intensive employment and demand generation character of the SME sector in Europe, positive externalities also follow from sound SME investments. Without entering here into the debate on existing fiscal rules in Europe (which do not make a distinction between current and capital public expenditure), it is clear that novel avenues should be found to revive capital outlays. This requires putting the long-term financing process on the right track in Europe: a multi-faceted effort in many areas.

2. Innovative financing for investment in Europe

Weak investment has gone hand in hand with a long period of contracting bank credit to the corporate sector. Fixing the banking system and deleveraging were necessary critical

steps; the decline in bank lending was due to both demand and supply factors. After the long-awaited AQR and stress tests conducted by the ECB (SSM), banks can again support lending, but the post-crisis financial reforms make it difficult for banks to directly play a key role in long-term finance. New constraints should be absolutely avoided.

The traditional strong dependence of Europe on bank intermediaries to channel savings into long-term investment must evolve into a more diversified financial framework with a greater role provided by capital markets and by institutional (long-term) investors.

To foster these developments and to remove barriers to long-term financing the Commission adopted in March 2013 a Green Paper which was followed by an exhaustive public debate. The Italian Banking Insurance and Finance Federation endorsed the objectives of the Green Paper and actively contributed to the public consultation. A key follow-up was the establishment through a corresponding legislation of the European Long-Term Investment Funds (ELTIF). ELTIFs can promote the creation of an important vehicle for investors. Regulatory adaptations are however required to attract institutional investors. The issues of product suitability for the retail sector deserve further careful attention. Fiscal advantages for long-term holding periods should also be introduced on a consistent EU basis. Detailed proposals on all these points have been made by the Federation.

3. Recent reforms in Italy

The Italian government has recently moved ahead with bold structural reforms in this field in order to diminish bureaucracy and simplify procedures, remove obstacles, facilitate access to credit, and support both public and private investment.

New legislation was enacted in order to create a regulatory and operational environment that is favourable to market financing and private debt, particularly for medium sized enterprises: i.e. the so-called “Mini-bond framework”. Mini bonds are especially tailored to the needs of small to medium sized companies. The Borsa Italiana (part of the London Stock Exchange Group) launched a specific platform to cater for such deals (Extra MOT Pro). As part of the wide-ranging law-decree Decreto sviluppo (2012) legal and tax obstacles to unlisted companies for issuing bonds were lifted.

As examples of credit liberalization measures, insurance companies and securitisation companies (SPV) are now allowed to lend directly to firms. New regulation has also liberalized direct loans from credit funds. Fiscal constraints were removed to provide better access to capital markets. Targeted tax-relief was also introduced to support investment (e.g. 25% tax credit on incremental investment in R&D).

Measures were introduced to reinforce companies capitalization, create incentives for funding on the stock market, through e.g. a more favourable Allowance for Corporate Equity (ACE), and to make it easier and cheaper listing in the stock market.

In the recently enacted “Sblocca Italia” decree, geared towards attracting private capital for new infrastructure and creating the ground for matching financing demand and supply, measures were introduced to make project bonds more appealing, incen-

tives to private investment in broadband and natural resources exploitation, and a new discipline for real estate investment trusts were established.

The Federation has actively contributed to the national debate on the improvement of the capital market and the promotion of long-term investment, through a Task Force with representatives from all the sectors of the financial market (insurance, real estate, pension funds, banks, asset management funds, etc.), chaired by Prof. R. Masera. This Group has also promoted a common approach of the whole Italian financial sector to the European discussion by responding to consultations, such as the one on the European Commission Green Paper on Long-Term Financing, and by promoting ideas and proposals.

4. The Juncker Plan: many opportunities and one (serious) constraint

The Juncker Plan was presented to Parliament on 26th November 2014. In its present formulation, which is still general and lacks details, the Plan looks well structured and promising. In fact:

- a) The plan is ambitious and comprehensive. It is based on a three pillars approach: a public European Guarantee Fund (the European Fund for Strategic Investment EFSI), a system of advisory promotion and support services, a deep reform of the regulatory and legislative environment aiming at a leap forward in the realisation of a “Single Market for investment” and a Capital Market Union in Europe.
- b) It is market-oriented, and directed at promoting investment that is financed in the market, or through the market, minimizing therefore the risk of wasteful public “white elephants”.
- c) It gives a key role to financial institutions and financial services, which are expected to contribute by channelling savings, evaluating and managing risk through screening and scoring of investment projects, and mobilising and extending the available resources through leverage and maturity matching.
- d) It is inspired by the subsidiarity principle (both horizontal and vertical subsidiarity), making sure that the public sector does not displace and crowd out the private sector. In the logic of the Plan in fact, the public sector – by providing guarantees – takes on risks that the private sector would not be able to take (risk taker of last resort).

There is only a problem in the Plan, and it is a dramatically relevant one. The fact is that the Plan focuses on measures aiming at structural and supply-side reforms. This is well grounded in theory and practise. But as we all know, structural reforms achieve results normally only in the medium/long-term, while the European economy needs to-day sufficient and credible signals and stimuli operating from the “demand side”. There is in other terms in the present plight of the European economy a cyclical, and therefore temporary, shortfall in demand, that requires a short term boost. An injection of aggregate demand that is capable of recreating confidence and reverse expectations of the economic agents, convincing them that the time for investment decision is (not later, but) now. Unfortunately in the Juncker Plan, at least at first sight, there seems to be

nothing of this sort, i.e. no element capable of counteracting the confidence crisis, i.e. acting from the “demand side”.

But we believe that this obvious, and much criticized, weakness of the Plan, can be addressed and corrected. This can be done by making use of the flexibility clause in the Plan.

5. Exploit the flexibility clause in the Juncker Plan

A very relevant aspect of the Juncker Plan is in the flexibility clause that it foresees. It in fact envisages the possibility for member states to contribute to the Fund (EFSI) with their own resources, and provides in return the benefit of excluding these member states' contributions from the constraints of the Stability and Growth Pact. Please note that this clause, fully justified by the exceptional circumstances of the short-term downside and deflationary prospects of the European economy, has nothing to do with the so-called “Golden Rule”, which in the past gave rise to heated and divisive discussions. The reality of the Stability Pact is that if some forms of controlled and limited flexibility are not provided it will itself engender, thorough depression and deflation, instability and financial distress. Therefore, this aspect of the Juncker Plan has to be welcomed and appropriately operationalised.

As will be indicated below, we believe that this feature of the Juncker Plan may play a key role and become an instrument for enhancing the financial resources of the Plan. Many analysts in fact have considered the financial resources of the Plan inadequate to the current needs of the European economy. Others more specifically have criticized the Plan as being too timid in terms of size of own resources, and too bold with reference to leverage. The suggestions detailed below are highly relevant to respond to these criticisms and avoid the repetition of the mistakes (and the lack of success) of the “Growth Initiative” announced in 2012.

Here is how we propose to interpret and complement the Plan, in order to give it also the capacity to impress a short term boost to investors' confidence:

1. Transfer resources from member states to EFSI, applying the non-inclusion clause relative to the Stability and Growth Pact. The corresponding amounts should be included in a kind of counter-guarantee Fund to be used pro-quota by the contributing member states to guarantee national programs of support to SMEs investment and assure “European” conditions (we assume that an AAA rating will be attributed to EFSI, borrowing it from EIB) to such national programs. This Fund, on a rotating basis, should work exactly like the Guarantee Schemes for EU mandates that are going to be transferred to EFSI from the EIB.
2. Like in the previous case, member states could, on a voluntary basis, transfer resources to EFSI not only to extend guarantees for investment funding, but also to finance a wider, immediate impact and temporary, cyclical program of incentives to private investments through tax cuts, in short a tax credit on investment (possibly) targeted to SMEs. In other terms, a member state may decide to transfer resources to EFSI for an amount equivalent to a tax cuts program in favour of investment (e.g. tax credits). In so doing the member state takes on the burden of additional

debt, but this extra debt “is looked upon favourably” at the EU level, i.e. the flexibility clause applies and the additional debt is not counted for the purpose of the Stability Pact. The mechanism could also work in an alternative way: companies pay their taxes, but the member state transfers tax revenues that are earmarked for investment incentives to EFSI. The Fund in turn gives this incentive back to the companies, after checking – based on documented evidence- that the investment outlays have been carried out correctly, and that the eligibility criteria have been fulfilled, etc. Therefore, it is EFSI that defines criteria, manages certifies and controls the incentive program, but the funding comes from the member state. In this way the credibility of the program is enhanced, the risk of spreading tax incentives too thinly and indiscriminately is avoided, and a rigorous and neutral assessment of the investment process is put in place. Moreover, the technical feasibility of this tool could be subordinated to its segregation vis-à-vis the other compartments of ESFI, so that it does not impact on its rating.

6. A European programme of Investment Tax Credits

Such a proposal, whose details have to be carefully analysed and spelled out, would have undoubtedly advantages both at the European level and at the level of the member states involved.

At the European level such a measure would provide a clear and strong cyclical back-stop to the short term outlook. It would be flexible, because it is left to the free decision of individual countries on the basis of their specific economic situation and requirements. It would not bend the obligations and the parameters of the Stability Pact, but only make use of a flexibility arrangement, justified by the current exceptional situation of deflationary risks.

The temporary increase of debt, that the tax cuts create, would be a burden only on the specific country concerned (no moral hazard), and would have to be recovered later, when the imbalance is redressed by returning within the limits of the Stability Pact. Finally, it would be politically important for Europe to be associated, for a change, in the eyes of the investors that benefit from the measure (particularly the SMEs), to a program of tax reductions and support to investment, rather than austerity, i.e. to policies geared towards economic growth and jobs.

For member states as well, and I am obviously thinking of Italy as a strong candidate for applying this measure, there would be many advantages. The proposal would make it possible to adopt an expansionary measure without affecting public budget constraints and the credibility of the European stabilization strategy. The fiscal push would be based on tax cuts, rather than on increases in public spending.

From the point of view of governance, the mechanism would be managed centrally and rigorously by EFSI, and would be based on the free choice of the single country concerned. There would be in other terms a transfer of sovereignty, and possibly an improvement in the programme management with likely gains in effectiveness and transparency.

Naturally this opportunity and “openness” in the implementation of the Juncker plan should be adequately argued and explained in order to avoid misconceptions and misunderstandings. It does not imply in fact any relaxation or bending of the criteria of the Stability Pact and it would not result in moral hazard. It would simply create flexibility in relation to the situation of exceptional economic difficulty, that endanger today the achievement of the objective itself of financial stabilization.

Besides, in order to guarantee an appropriate standard of administration transparency and control, the measure implies a transfer of prerogatives and controls from the national level to the European one. There would be no increase in debt, and no cross country transfer of debts at the European level. Only – temporarily and exceptionally – the national debt of the country in question would increase. Therefore it would have nothing to do with the (permanent) exclusion of some kind or type of public expenditure from the Maastricht criteria (the so called golden rule).

The Italian Presidency of EU should exercise all its influence and moral suasion to well explain and argue these concepts in order to dispel suspicion and mistrust from creditor countries, and public opinion. Moreover, countries that intend to use the flexibility clause in the way we are suggesting should create their own National Funds for Strategic Investment, which would then be passed on to the European Fund. The relationship between the National and the European Fund should be fine-tuned to strike the right balance between national requirements and central credibility.

7. Strengthen the investment capacity of the European economy and society

Channelling financial resources towards investment is not a sufficient condition to bolster capital accumulation. The Juncker Plan in its second pillar rightly points out that a major effort is required to get sound projects going, i.e. investment projects that can be financed either through taxation (public investment) or through the market (private investment) or through a Private Public Partnership (PPP).

The Plan identifies various mechanisms, which in principle we believe could have real value added. Among them:

- a partnership between the EIB and the EC to provide support and carry out projects.
- an investment advisory hub based on a single portal for promoters, investors and public managing authorities.
- strengthening the network of National Promotional Banks, and similar bodies across Europe
- intergovernmental cooperation to collect, strengthen and prioritise projects at national level, building on the work done under the leadership of the Italian EU Presidency by the EIB – EC Task Force with member states

We recognise and support the importance of this effort and the various mechanisms that have been proposed.

But we underline three essential conditions that need to be taken into account:

- 1) more than “hubs”, “portals”, partnerships and networks we need a single, fully-fledged “system” of advisory promotional support services, with a clear strategic

orientation, lean cost-effective structure and real coordination powers. We need to avoid overlaps, duplication and bureaucracy; apply the subsidiarity principle (also when it suggest to bring at EU level functions that are now fragmented and ineffective); rationalize and simplify existing institutions; streamline the use of the limited public resources available.

- 2) Rely on the private sector and the market for advisory promotional and support services, including the possible role of business association. The financial sector has in that context a lot to offer, thanks to its screening and risk assessment capacity, its multiple and varied distribution system; its different business models.
- 3) Invest in education and training. We need a new, more advanced and more European “investment culture”, particularly for younger generations. This culture is not a raw material, but should be developed through education and training.

8. Build a “Single Market” for investment, that is really “single” and really “European”

The third pillar of the Juncker Plan is the most ambitious and fundamental one.

Without an investment environment that is able to energise and mobilise investment by all decision makers, at all levels, including households, SMEs and local communities, the Juncker Plan will not reach its long-term objectives of stimulating economic growth and fighting unemployment.

Ultimately, an investment inducive environment implies nothing less than a “Single Market for Investment” in Europe. Therefore we could say that this objective is not new, just a reformulation of that distant and comprehensive goal adopted in 1992 (the single market) and re-launched at several occasions through waves of liberalisation and re-regulation (lastly with the Monti Report of 2010).

However, the fact that more than 20 years on from 1992, barriers and obstacles to investment have not been eliminated, and that in some case they may have even been increased (e.g. in the case of banks after the crisis and before the Banking Union) shows how challenging is this part of the Juncker Plan. Basically, we need to learn from past failures and success. In particular, the experience with the Banking Union is very relevant to understand what are the stumbling blocks to reform and how we can make progress (the establishment of the Banking Union was in retrospect relatively fast and smooth).

Based on the lesson learned, we believe that 3 aspects of the Juncker Plan under this pillar deserve strong endorsement and support, and that 3 conditions have to be realised if we want the Plan to achieve its stated goals.

The 3 important acquis are the following:

- 1) Move rapidly and effectively towards achieving a Capital Markets Union;
- 2) Remove barriers in the infrastructure sectors identified in the Plan, namely the financial sector, telecommunications and the digital economy, energy, transport, services and related sectors.
- 3) Make the regulatory environment simple, clear, predictable and stable. Administrative burdens and regulatory complexity affect negatively investment, particularly by SMEs, and – in the global competition to attract funding- they penalize our continent.

But there are 3 further conditions, which we have to keep in mind if we want really to achieve success:

1. A single market requires a single rulebook! “Single” should be understood here to mean what it means in plain English: i.e. “single”, not an additional layer of common principles or a set of general rules that is added up, on top of 28 separate regulatory regimes. Harmonisation is a step forward, but is not sufficient for a single market. Harmonised rules will create harmonised (but separate) markets, not a single market. Moreover, it risks adding to the regulatory burden (e.g. in the case of gold plating) and producing duplication overlaps and confusion.
The same principle (single institutional mechanisms for a single market) should be said of supervision, resolution and guarantee mechanisms.
The implications of the “single rulebook” principle are wide-ranging and should be pursued with realism, gradualism, but also strong determination.
2. All investment sectors should be considered (not only the most obvious and open ones), including in the list those of national (and local) champions, special interests and government monopolies, such as research and universities, welfare systems, media and television, etc.
3. The institutional architecture matters. Like in the financial sector, to consolidate in single (set of) authorities the powers that are now fragmented across a myriad of national and local institutions would be a great and necessary step forward.

In sum the litmus test for the single market to work can be considered to be two-fold:

- 1) Eliminate barriers, encourage players and resources to move freely across borders, make the market more open and larger, the institutional framework lighter, the regulatory environment simpler and more effective.
- 2) Transfer powers and prerogatives from the national level to the level of the European single market.

Long-Term investments in Europe from the financial crisis to the Juncker Plan¹

Franco Bassanini, Edoardo Reviglio

After the financial crisis, some of us expected a more radical paradigm shift in the foundations of contemporary capitalism. None of that seems to have happened. Extraordinary transformations are underway (globalisation, digitalisation, robotics and nanotechnologies, huge migratory flows and decarbonisation). Extraordinary transformations are expected over the coming decades, both in the probable emergence of a new multipolar world and in the political-cultural underpinnings of the great machine of global capitalism².

One concept that had some significant impact is the recognition of the importance of long-term investment against short-termism and speculation. The authors have been working on this for many years, as have many others: some significant results have been achieved, both in Europe and globally, but more at the political-cultural level rather than with concrete policy actions.

The aim of this paper is to review the principal events that have characterised this intellectual and policy making process. In the second part, we will concentrate on what has been achieved in Europe on supporting long-term investment – up to the most recent initiatives to promote investment and finance for growth (in particular, the “Juncker Plan” and the introduction of some budget flexibility – the Golden Rule – in the financing of infrastructures and SMEs).

A brief chronology of the concept of long-term investment from 2008 to date

It is thanks to a close cooperation between Italy and France that the subject of long-term financing of the economy was first introduced and developed in Europe and from there was extended to include, through the G-20, the rest of the world.

- 1 The first part of this paper is partially taken from a report on the Italian French Seminar on “The Challenge of Long-Term Investment for Europe: a French-Italian view”, organised by the Cercle des Economistes and the Italian Embassy in Paris, on 16 May 2014.
- 2 Cfr. F. Bassanini and E. Reviglio, E., Financial Stability Fiscal Consolidation and Long-Term Investment after the Crisis, in *OECD Journal of Financial Trends*, vol. 1, 2011, pp. 23-63.; Bassanini F., Obstacles to the Global Deployment of Investment, in *Astrid Rassegna*, n. 18/2011; F. Bassanini and E. Reviglio, National States Sovereignty, Democracy and Global Financial Markets: the European Issue, in *International Economics/Economia Internazionale*, 2, 2014; E. Reviglio, The Problem of Us and the Others. The Great Challenges of XXI Century, in *International Economics/Economia Internazionale*, 2, 2014.

In autumn 2008, the leaders of the four major national public development banks met in Paris at the Hotel de Pomereu, the historical headquarters of the Caisse des dépôts et consignations³. The meeting, endorsed by the European Council, had the purpose to begin to study the feasibility of creating a large European fund for infrastructure and energy. The idea of the European Fund had been presented by the Italian Minister for the Economy and Finance at the informal Ecofin on 28 September 2008. The proposal arose from three considerations: (1) to give a strong political message on the need to strengthen the long-term funding of the European economy at a time of deep crisis and confusion; (2) to support the recovery of the infrastructure financing market (and SMEs) in the EU; and (3) to create a network among large European national promotional banks in favour of the long-term growth of the European economy.

Since then, a substantial amount of progress has been made. Not only in Europe, but throughout the world. The need to boost long-term financing of the economy is on the agenda of Governments, large international organisations, national and international regulators, the G-20, the market and the European Union. In Europe, in particular, the Commission has produced an “Action Plan” which defines the road map for the new European legislature. It contains a series of clear directions. For some there is a broad consensus, for others less so. Some are technically easier to carry out, others harder. In general, however, the market, the banks and businesses are, at least in principle, in favour and are pushing for many of the proposed initiatives to be launched. Governments and the EU are aware of this and recognise its urgency. After eight years of words it is time to move on to deeds.

But before going into the more technical sections of this paper, we will try to recall, very briefly, in chronological order, the main proposals and initiatives which have occurred at European (and global) level, in the area of long-term investment.

In December 2008 the European Council gave the green light to the establishment of the Marguerite Fund, which became one of the main Greenfield funds in Europe. In the early months of 2009, Caisse des Dépôts, Cassa Depositi e Prestiti, the EIB and KfW created the Long-Term Investors Club (LTIC)⁴. In June 2009, the first Annual Conference of the Club was held with the participation of some well-known economists⁵, as well as representatives of the national and European institutions, of the financial industry, of investors and the international press. The OECD participated as a co-sponsor of the Conference and from that moment became a stable partner for many of the initiatives of the Club. The subjects addressed in the first Annual Conference of the Club were: the need for long-term investment for growth and stability; the financ-

3 The idea to introduce the concept of long-term investment in the European and global agenda was first proposed in 2008-2009, and afterwards strongly supported, by the President of the EIB Philippe Maystadt, the Head of Institutional Relations of EIB Dominique de Crayencour and the DG of CDC Augustin de Romanet.

4 For a description of the LTIC and the events promoted, see www.ltic.org.

5 These include Olivier Blanchard (Chief Economist of the IMF), Pier Carlo Padoan (former Chief Economist of the OECD) and Nouriel Roubini.

ing of infrastructure and SMEs; the relationship between long-term investment and accounting standards; and the relationship between the short- and long-term visions of finance. Over the years, the thinking of the Club has evolved. A Scientific Committee was established which initiated series of joint working groups which have addressed subjects related to long-term investment.

On the European front, on 25 February 2009 the de Larosière Report on financial supervision was delivered to European Commission President Barroso⁶. It addressed the subject of accounting standards, claiming that the business model of intermediaries should be taken into account, especially if made up of long-term assets and liabilities, and that the standards should promote anti-cyclical behaviour and long-term investment should be encouraged or at least not penalised compared to short-term financial investment. In addition, in terms of corporate governance, a review was suggested of the remuneration system, in order to favour the interest (not short) but long-term of the shareholders and of the company.

In spring 2009, the EIB, together with the European Commission, delivered a proposal for a programme to support the subject of project bonds to finance the TEN-T and TEN-E projects and the digital infrastructure. The European banking system and the financial market were in crisis. The demand for debt of the major European infrastructure projects did not find a corresponding offer from the European banking system. The idea behind the Project Bond Initiative, as noted, was to issue bonds with an EIB guarantee (financed by the EU with funds from the “European Connecting Facility”) for the investment projects of the Lisbon Agenda in transport, energy, climate change and broadband. It was to take another four years to start the experimental phase of the so-called Project Bond Initiative. Up to now it seems to be progressing quite successfully. Insurance and pension funds have shown great interest to buy the new bonds of the first projects. In the next few years we could see the emergence of a new market for these instruments.

In September 2009, the Club participated in and began to work on the subject of long-term investment with the Eurofi Think Tank, an important occasion for policy makers, economists and market operators to exchange ideas, under the leadership of Jacques de Larosière. At the Gothenburg Conference during the Swedish Presidency, the authors of this chapter presented a paper entitled “New European Institutional Long-Term Financial Instruments for a Strong, Sustainable and Balanced Global Growth” which analysed: a) the importance of investments made with long-term private saving in the exit strategy from the crisis, thanks to their multiplier effect on the denominator of the public debt/GDP ratio; b) the need for less strict prudential and accounting regulations for medium-long-term investments in infrastructure and in the real economy. It was also argued that the EU should: c) create the right regulatory framework to attract long-term investors from Europe and the rest of the world; d) raise the credibility of the euro and the process of fiscal consolidation already achieved; “cash in the dividend of

6 The High Level Group on Financial Supervision in the EU, Chaired by Jacques de Larosière, Bruxelles, 25 February 2009.

the policies of austerity and good management of European public accounts”; e) create common financial instruments through the network of the large public national and multi-lateral development banks, in the area of risk, debt and guarantees; and introduce Eurobonds for growth and project bonds for infrastructure.

The intervention was greeted rather coldly by most of the participants. The exception was Jacques de Larosière who immediately grasped the spirit of the initiative and encouraged us to continue to work on topic of long-term. The following year, the subject of long-term investment was then included as one of Eurofi’s main issues, and since then it has collaborated with the Long-Term Investors Club supporting both politically and culturally more favourable regulations to investment in infrastructure and the real economy. Since 2009, three other influential European Think Tanks (Confrontation-Europe, Astrid, and Bertelsmann Stiftung) supported LTIC and Eurofi in re-launching the subject of long-term investment.

On 9 May 2010 the so-called Monti Report⁷ was delivered to President Barroso in which the subject of long-term investment (and the regulations and public policies) became central to the debate on the creation of the single market and of the search for an exit strategy from the crisis. A series of European Commission communications followed, which also supported the need to sustain long-term investment to stimulate growth, employment and fiscal consolidation, as well as to set out a more favourable regulatory framework⁸.

However, very little actually happened. The transposition of the Basel III rules, with the CRD IV directive, and the regulation of the insurance sector ensured by Solvency II continued to penalise medium to long-term investments in the real economy. Something changed at the beginning of 2015, as will be seen later, with a first opening to the application of the flexibility rules contained in the Fiscal Compact and with the Juncker Plan and even more recently with the “Action Plan” on the Capital Market Union (CMU).

The subject of long-term investment also attracted the attention of scholars and financial operators overseas. At the Center of Global Thought at Columbia University, chaired by Joseph Stiglitz, the first of a series of conferences was held in October 2010 entitled Sovereign Wealth Funds and other Long-Term Investors: A New Form of Capitalism. Our paper entitled Financing Long-Term Investment after the Crisis: a View from Europe received unexpected interest among American economists who saw in the long-term oriented social economy of the European market a model to reduce short-termism and the financial industry’s tendency to speculation⁹.

The Obama Recovery Plan in 2008 had decided to allocate over 800 billion dollars in the modernisation of the outdated American infrastructure system, through a

7 A New Strategy for the Single Market. At the Service of European Economy and Society, Report to the President of the European Commission by Mario Monti, May 2010.

8 See EU, Finance for Growth, Brussels, October 2014.

9 F. Bassanini, Financing Long-Term Investment after the Crisis: a View from Europe, in Sovereign Wealth Funds and Long-Term Investing, by Patrick Bolton, Frederic Samama, and Joseph E. Stiglitz, Columbia University Press: New York 2011.

panoply of different instruments and interventions (from guarantees, to tax incentives, to grants, etc.). Soon after the onset of the crisis, the leaders of the EIB were received by the U.S. Treasury to evaluate whether to establish an American Infrastructure Bank on the model of the Union's large multilateral bank. At the same time Obama launched a Project Bonds plan known as Built American Bonds, which enjoyed significant tax incentives which made them as attractive as State securities or municipal bonds. BABs allowed more indebted municipalities to avail themselves of additional finance in municipal bonds without increasing the local debt, as project bonds are not consolidated in the debt of the municipalities. In only 18 months the BABs market reached 200 billion for investments in infrastructure¹⁰.

On 18 February 2011 at the EUROFI of Paris, the leaders of the four founding members of the LTIC (EIB, KfW, CDP, CDC) held a meeting with Mr Mario Draghi, then Chairman of the Financial Stability Board (FSB), during which they raised the issue of the application to the national development Banks and more in general to long-term investors of the capital and liquidity requirements laid down by Basel III and by Solvency II, as well as the subject of the relationship between the business model of the various long-term institutions and the mark to market philosophy which is the foundation of the International Accounting Standards (IAS).

Draghi explained the reasons for which he did not deem appropriate a review of the capital requirements of Basel III, but left open the subject on the adjustment of the liquidity ratio and the accounting standards as well as the definition of the scope of application of the Basel rules that might rule out or mitigate their application to Promotional Banks (PBs). More in general, he stated that he was in favour of differentiated adjustments according to the specific business models of the different categories of institutions, capable of adapting to the specificities of the main categories of long-term investors (pension funds, life insurance, sovereign funds, NDBs and NPBs, etc.). A few years later, upon the order of the G20, the FSB produced a report on the topic of the LTI in which the question was discussed for the first time.

The debate is still open. A special LTIC WG has been discussing the issue with the FSB. As regards the accounting standards, the question is whether it is appropriate to introduce an additional category for financial assets which do not fall within the definition of amortised cost or in that of fair value through the category of the profit and loss account for financial assets which are on the books in the medium and long-term. The hope is that this dialogue will provide solutions which do not more penalise those institutions which have a business model based on long-term assets and liabilities (such as pension funds, insurance companies and SWFs) or which operate on a long-term and the public interest mission (such as national and multi-lateral development banks). After all, the concept of "value in use" is already defined in IAS 36 – Paragraph 6: "Value in use is the present value expected from an asset." This definition could be extended

10 See F. Bassanini and E. Reviglio, *European Institutions and the Crisis: Investing to Grow and Compete*, English version of a chapter from the ASTRID research report: *Prove di Europa unita. Le istituzioni europee alla prova della crisi*, G. Amato, R. Gualtieri (eds), Passigli Editori: Florence 2013.

to financial assets held by institutions which intend to keep them in their portfolios for a long period of time. Thus, this would prevent the main indicator for measuring the profitability of an asset from being distorted by short-term fluctuations. Albeit logical, such an address would find technical and ideological barriers difficult to overcome.

The debate on the role, regulation and means of financing long-term investments has intertwined in recent years with the one on the role of commercial banks in financing the real economy and infrastructure after the Great Crisis. Since the outbreak of the crisis, Jacques de Larosière has reminded us that the European banking system is bank-oriented, while the American is market-oriented. So the Basel III “cost of stability” is much higher in terms of financing the real economy in Europe than in the United States¹¹.

In 2011, CDP raised this subject within the LTIC claiming the need to begin to investigate the role of long-term institutional investors such as pension funds, life assurance, and sovereign wealth funds in the financing of the economy and infrastructure, including bypassing the medium-term negative effects of Basel III on long-term financing by Europe’s financial system. We thus began to explore the subject of asset allocation of pension funds and insurance (subject on which the OECD had already begun to work) and the un-intended effects of Solvency II on LTIs. We anticipated that a demand for long-term investments if it were to be satisfied, it would have to be structured as a new “asset class”.

Today the subject raises the attention of the financial market, which sees great opportunities for profit and/or stability in entering/investing in this new asset class. In our first paper on the role of institutional investors in long-term investments, we addressed the subject of the excessive weight that Solvency II would discourage insurers to hold infrastructure assets, despite statistics showing that project bonds have a better recovery rate than corporate bonds, which instead require a higher capital absorption than loans for project financing¹².

11 On the asymmetrical effects of prudential regulations and accounting standards see F. Bassanini, The Juncker Plan, Key-note speech at the European Parliament, Brussels 2015, now in Astrid Review, n. 7/2015 (“We should not forget that one of the fields on which global competition is playing its game is the setting of prudential regulations and accounting standards. The tough prudential and accounting regulation which penalize the financing of real economy and infrastructures has become a major weapon in the global economic and financial war, which characterize the XXI Century, hitting Europe more than others economies. The EU financial system, which is more bank-oriented than most of other major financial system in the world, pays in fact a greater price due to prudential regulations and accounting standards unfriendly to LTIs and to the financing of the real economy. This is not the case for market-based financial system such as the US and Government based financial systems such as China. Moreover, the UE Member States have stricter space of manoeuvre in the substitution of banking financing with State Aid. Finally, the European political and regulatory Authorities are always much more rigorous in the transposition and implementation of international regulations and generally provide less exemptions and less flexibility than those of other major countries (see for instance the transposition of Basel II and Basel III made in the US)”).

12 F. Bassanini, G. del Bufalo, E. Reviglio, Financing Infrastructure in Europe Project Bonds, Solvency II and the “Connecting Europe Facility”, article prepared on the occasion of the “Eurofi Financial Forum 2011” which was held in Wrocław, on 15-16 September 2011, during the Polish Presidency of the EU.

In March 2013 the European Commission adopted the “Green Paper on the long-term financing of the European Economy”. The Green Paper represents an important step forward by the EU in recognising the importance of long-term investments. Most of the of the proposals put forward by LTIC in the previous years were taken into the Commission’s document.

The Report on SME and European infrastructure financing went to print in December 2013. It was prepared by a High Level Expert Group at the request of the Irish Presidency of the European Union. The EU reached the turning point in its looking at long-term financing in Europe¹³. In mid-April 2014 the European Parliament, after a year’s work, voted on the Report for constitution of the European Long-Term Investment Funds (ELTIFs). This involves creation of a European fund for financing Small and Medium-Sized Businesses and other long-term investments. One of the subjects widely discussed at present is the possibility that retail investors may also have access to the Fund.

Finally, in the spring of 2014 the EU published a Communication known as “Action Plan for Long-Term Financing of European Economy”, indicating the challenges of the European political agenda in terms of long-term financing for the new legislature.

The awareness of the importance of long-term investment on the global level was finally included in the G20 conclusions of the Russian Presidency in September 2013. Also, the Australian and the Turkish Presidency of the G20, which have followed the Russian one, has emphasised this subject, focusing in particular on infrastructure.

Furthermore, since 2009, the OECD has been involved in LTIs: has created a databank on institutional investors Asset under Management worldwide and conducting studies on the role of institutional investors (pension funds, insurance companies and SWF) in the financing of long-term investments. In 2013, the OECD created a taskforce which drafted the “Principles of Financing of Long-Term Investments” by institutional investors, approved by the G20. Among international institutions, the OECD is the one international institution that gave the most convincing and important contribution with the creation of databanks, publications and congresses on LTIs. Given the interest of the Russian Presidency of G20 in the subject, also the World Bank, the International Monetary Fund and the Financial Stability Board (FSB) have been involved in the preparation work and are now also an part of the international institutions supporting a less penalising regulation for long-term investment.

Long-Term investment

The search for a scientifically rigorous definition of “long-term” has already resulted in an wide literature. Amongst the many suggestions, we would like to limit ourselves to a short summary of the definition recently developed by the OECD.

13 EU, Finance for Growth. Report of the High Level Expert Group on Infrastructure and SMEs Financing, Brussels, 11 December 2013.

The concept of “long-term” refers to financing with a duration of at least five years. The definition is not limited to the duration, but also includes the condition that the investments must be relatively stable in time. It identifies a set of criteria, which institutional investors may use to identify them:

- (i) they constitute a productive capital supporting infrastructure financing of “green” growth and financing of small and medium-sized businesses;
- (ii) they are patient capital permitting investors to have access to a so-called ‘illiquidity premium’, rarely requiring refinancing, they contribute to the reduction of diffusion of pro-cyclical investments, assure net rates of return on investments that are non-speculative and stable in time, assuring a higher financial stability for the investor;
- (iii) they represent dedicated capital, encouraging active voting policies, which in turn improve the quality of corporate governance.

*Financing of infrastructures*¹⁴

The International Monetary Fund, in the 11 September 2014 edition of its World Economic Outlook states that a better public infrastructure system is crucial. The positive effects of investment are greater in periods of low growth or recession, provided that the investments are highly efficient. If well-conceived, the multiplier is higher than the cost of the debt contracted to finance the investment. Economic theory tells us that investments are important elements to re-start growth, increase competitiveness and eliminate imbalances. Investments in infrastructure, innovation, R&D, technology and human capital, above all, have significant positive effects on potential GDP. The debate in the economic literature differs only in its assessment of the size and shape of the phenomenon. According to the latest calculations by the International Monetary Fund, greater investment in public infrastructures increases output, in the short term by stimulating demand, and in the long-term by raising the productive capacity of the economy. In a sample of advanced economies, investing an additional 1% of GDP has a 0.4% effect on output in the first year and 1.5% in the following four years. Obviously, an increase in GDP due to the effect of investments is greater than the increase in debt, so the ratio of debt to GDP falls. In other words, public infrastructure could pay for itself if done the right way.

Infrastructures, during this transition phase, are characterised by certain idiosyncratic features, typical for newly constituted markets. The financial offer is once again abundant but the pipeline of bankable projects is still narrow, even in the most advanced markets, such as the European market. One example is sufficient: one of the largest Greenfield funds, operating in Europe analysed, in the last two years, about 500 projects in the sector of energy, transport and broadband in the 28 EU member countries. Among these, it decided to co-invest in the equity of only 9 of these. Other Greenfield funds operating in Europe have a ratio of projects analysed and projects, in which it was decided to invest, that is slightly higher, but in any case it remains, on average, well below 30%.

14 Cfr. Reviglio, E., (2014), Come finanziare le infrastrutture con risorse pubbliche scarse, Discussion topics, in *Economia Italia*, 2, 2014.

This is worrying and means that much still has to be done to launch PPP in Europe. There are few “investment grade” projects in the pipeline, i.e. projects that are not only bankable but adapted to more prudent categories of investors on the capital market, such as pension funds and life insurance. The complexity of construction and financing of major projects, especially in sectors with high technological content or with high regulatory or macro-economic risk, requires a complex agreement with various entities working together like an orchestra, and not for a short period of time, but in many cases for 30 or 50 years. The public sector, for example, in various EU countries, does not always seem to be at the height of its duties, both technically and in political, regulatory and administrative terms. The EU can and must do a lot on this front; but also the individual member countries must work on the regulatory framework and the technical quality of the public structures involved, with different roles, in PPP initiatives. The next-generation model in the financing of infrastructure that is emerging globally represents a real new frontier in making investments. Processes and models are more complex than in the past and pose on-going challenges to all players involved (public sector, private sector and financial community). The Smart Cities of the future, for example, will be made up of integrated infrastructure systems and may be effectively carried out only by means of innovative ad hoc financial structures.

But who are the potential lenders of PPP works? And what are the most suitable financial products? In the financing of medium and large Greenfield projects, the instruments available to long-term institutional funds (pension funds, insurance, etc.) are currently limited to the following: (i) shares of capital in private equity funds or in individual projects (“unlisted equity”), in the latter case possibly alongside highly reputable private equity funds, which act as anchor investors; (ii) project bonds guaranteed by the EIB (in this case, the guarantee and the illiquidity premium justify a higher yield); and (iii) through direct participation in the debt of the work either on one’s own account (“shadow banking”) or alongside other intermediaries.

This type of investment is limited to pension funds or large insurance companies, the only ones able to create internally or acquire from the market “independent evaluation capabilities” of these instruments. The numerous smaller pension and insurance funds find it very difficult to invest in this type of instruments on an individual basis. Thus, in some cases, they are forced to create alliances with one another sharing the cost of external analysis capacity. In general, the new model of non-banking infrastructure financing may require the creation of a new category of intermediaries, capable of acting as a bridge between investors and investments.

The same type of scheme applies to medium-size and large Brownfield projects. However, the competences required are different and the yields are lower on average insofar as the risks should also tend to be lower. Currently, the demand for Brownfield projects from investors is much higher than for Greenfield projects. However, in general, in the coming decades, especially in the emerging economies, but not only, the need to build new works will exceed the requirements to manage and modernize existing ones.

Naturally we are speaking of the project financing market, which represents only 10% of all infrastructure financed in Europe. The remaining 90% is financed either by

the public or corporate sector. In the former case the Government pays the entire cost of the project through general taxes. In the latter, on the other hand, companies guarantee the risk with their balance sheets. In this second case investors may invest in stocks or corporate bonds issued not by individual projects, but by the company building the infrastructure.

Pension funds, insurance companies and sovereign funds manage, globally, around 90,000 billion in assets. They are not asked to allocate a major share to infrastructure or to become the main investors thereof. It is about encouraging the emergence of a new model in which this type of investor is put in a position to increase by at least two or three times their investment capacity in the infrastructure as an asset class. By encouraging a greater allocation from institutional investors in infrastructure investments, for example from the current 3% to even just 5% of the total assets managed, it may be possible to obtain additional resources of around 2,200 thousand billion dollars globally (source, HSBC, 2012). Currently, Canadian and Australian funds already invest about 15% in infrastructure. We do not believe it possible to reach that figure in other countries in a short space of time, but getting closer to that threshold should be in the long-term a goal to be pursued.

The situation is different – but of no lesser importance – for smaller PPP, for example social and urban infrastructures (hospitals, schools, day-care centres, subsidised housing), energy or other infrastructure, but still of medium or small size. If we also want long-term institutional investors to be able to finance this type of projects, at least partially, it is necessary for the projects to be standardised and collected in dedicated portfolios. This poses some challenges, which should be at the centre of EU and member states' policy actions in the next legislature.

Perhaps it may be useful to mention the new structure of school construction in the United Kingdom, using new generation schemes in a country where PPP was born and has developed with some success. In short, the scheme is as follows: the process is centralised and managed for the public sector directly by the Government. Each Special SPV builds groups of nine schools, called “batches”. The Government pays an availability fee for thirty years to each SPV (a sort of financial lease). The batches are then bundled in portfolios, issuing shares of 2-3 billion each, which at that point are acquired by the capital market, entering into the portfolios of institutional investors.

The EU also encourages other member States to finance investment using this type of structure, but the process is slow in taking off. Why are there still so few standardised PPP operations, combined in single portfolios, conducted in many states of the Union? There are many reasons and some of them depend on the country. A fairly common problem is the absence of technical capabilities of public administrations compared to highly complex contractual schemes. Ad hoc agencies, which many governments constituted to provide technical assistance to public administrations, turned out to be generally inefficient.

The PPP investment policies must be reconsidered and re-launched in the European agenda with bolder policy actions. But to become successful what should the new model be? What do we need to do? First of all it is fundamental to centralise management and

standardise the PPP schemes. Considerable human resources (teams of experts) must also be invested to start the process, which currently seems to be the only solution to the problem of reconciling high public debt, high social costs, low growth and high demand for investments, which currently characterises and will continue to characterise European economies for the next decades.

With public debts that are so high, and will probably remain high for many more years, the future of infrastructure financing in Europe must necessarily involve a change of model. In our opinion, the new model should be technically very expert, capable of increasing the efficiency through economies of scale through standardisation, consolidation and privatisation of public service companies, through creation of dedicated national funds or a single fund or a European fund of funds.

At the same time it is necessary to concentrate also on the role of investments in business infrastructure. If these make up about 40% of infrastructure in Europe, why not provide special tax or other instruments to facilitate and encourage the large and small corporations that make investments in tangible and intangible infrastructure? Why not seek new forms of collaboration and blending between PFI, investments by large corporations and the public (Europe and the Member States) through new financing instruments and public and public/private guarantees? Why not join forces with large European companies that manage energy, transport networks creating special JVs or “Common European Companies” – among other things provided for in the European Treaties?

Financing and the securitisation of SME loans

The crisis has weakened the ability of the European financial system to channel savings into productive investments. In general, in the countries’ worst hit by the recession and the crisis, there is a climate of uncertainty and risk aversion which hinders their capacity to invest, particularly in infrastructure and SMEs. Committed to reducing the lever to correct the excesses of the past, European banks have reduced their capacity to provide medium- and long-term loans. At the same time, the crisis has had negative effects on the borrowers’ and institutional investors’ confidence and appetite for risk. Credit volumes have contracted in recent years. Signals of difficulties in financing channels to mid-caps, SMEs and families are clear, and causing growing concern. The securitisation and risk capital markets in Europe are still relatively undeveloped compared with other economies and the non-banking channels are still not accessible to SMEs.

Launching the securitisation of loans to SMEs market in the EU could be a useful initiative to free up capital in banks balance sheets’ and restart lending. The EIB’s SME Initiative is a step in this direction. The ECB has also recently stated that there is a need to develop financial instruments that can be priced in a simple way.

In fact, securitisation in Europe has never taken off. According to a recent proposal of Jacques de Larosière, there needs to be three kinds of action¹⁵. It is first necessary to re-

15 Cfr. Jacques de Larosière, Reviving Securitization of SMEs Loans in Europe, Eurofi, Athens 2014.

store investors' confidence. This means that the quality of bank lending must be beyond reproach. Considering the criteria already established by the central banks for accepting loans to SMEs as eligible collateral and the ability of central banks to estimate the risks of these products, the definition of high quality standards for the securitisation market could be easily achieved. On this basis, the Euro-system could promote the development in each country of a European securitisation channel through which loans to SMEs could be acquired that satisfy the "minimum" quality standards and would therefore guarantee issues of "Prime Securities". A second condition should be access to guarantee schemes for the European and/or national development banks for the securities issued. The high quality of the underlying loan together with the public guarantees would give institutional investors the possibility of investing in long-term financial products linked to the real economy. Finally, the ECB, in concert with the national central banks, should be ready to temporarily purchase Senior and Mezzanine tranches, if necessary, to facilitate the launch of the European securitisation market.

*How to relaunch the European securitisation market*¹⁶

The loan securitisation process is therefore a tool of particular importance to finance the economy in Europe, and represents one of the priorities indicated in the Green Paper by the Capital Markets Union (CMU). The launch of the asset-backed securities (ABS) market is probably the tool best suited for financing the economic recovery in Europe, and of SMEs, since SMEs provide two thirds of the employment and 58% of the added value of the European Union. But as we have seen it is not an easy tool, and not an easy market, particularly for loans to SMEs. The question of securitising loans for project finance for infrastructure is also important, in the near future. This is an essential step to create a new asset class for financing infrastructure, and is a key component of the Juncker Plan for investments¹⁷.

The benefits of overhauling this market are self-evident. If properly structured and regulated, loan securitisation transactions could represent a bridge between bank finance and market finance, and can supplement long-term wholesale funding for the real economy, particularly for SMEs. Placing a major share of the securities deriving from securitisation transactions on the market would create a source of diversified finance for banks that, by transferring part of the credit risk to non-banking financial institutions, should free up enough capital to generate new loans in the real economy. Moreover, and particularly in the current macro-economic context, securitisation transactions are able to guarantee the effective transmission of cash deriving from the accommodating mon-

16 This contribution is largely based on the notions and considerations set out in the paper by F. Bassanini, G. del Bufalo, R. Masera, M. Minenna, E. Reviglio and G. Zadra, entitled Quantitative Easing structured finance and support to the real economy. Proposals on ABS, published in SSRN, November 2014 (see below Annex, pp. 299-309).

17 F. Bassanini and E. Reviglio, Why infrastructure investment needs to become a real asset class, OMFIE, London, 25 May, 2015.

etary policy of the European Central Bank (ECB) through the banking channel, and can also, finally, supply indirect market access for groups of end borrowers that would otherwise be excluded, such as SMEs, for example. However, to reactivate the large scale use of securitisation operations, the errors of the past must be avoided. It follows that it is advisable to define some guiding criteria on the quality of the underlying loans, and to opt for simple and transparent securitisation techniques.

It seems to us that there are two main problems for a recovery of the ABS market for SMEs in Europe. The first is the heterogeneity of the underlying (loans). The second is the availability of credit information. In general, the banks have all the information necessary, but it is not homogeneous throughout Europe. So there is a need to construct a platform of homogeneous and sufficiently detailed information. Transparency for the purpose of ABS market efficiency is an essential prerequisite. Configuring the information requirements on single loans as part of the criteria for the admissibility of collateral by the ECB, as is done in France, and referring to classifications of market-friendly securitisations are steps in the right direction.

There are as yet no homogeneous criteria for risk assessment, and there is no harmonised definition of Non-Performing Loans (NPLs). This makes it difficult to compare operations in the different member states. The CMU represents a unique opportunity to consider and find solutions. Today we have the technology needed to do it¹⁸.

Proposals to encourage long-term investment in Europe: an overview

A common European policy is necessary for the promotion and support of long-term investment. The main pillars of this strategy should be the following.

The definition of a regulatory framework more “favourable” to long-term investments. Currently, the main accounting rules and supervisory requirements (Basel III-CRD IV, Solvency II, the IORP, IFSR) still tend to favour the short-term and penalise the long-term investments. Some recalibrations (especially in terms of liquidity ratios and capital absorption for certain classes of assets) are difficult but necessary. The same applies to Solvency II. It is not about ignoring the need for strict rules in order to protect financial stability, but fine-tuning them to make them compatible with the need to finance investments in infrastructure, innovation, R&D and technology, needed to boost growth and competitiveness, which in turn are enabling conditions of the long-term sustainability of the fiscal consolidation processes. Pension funds will, it is hoped, capitalise on the work done by insurance to obtain some significant changes. In any event, if there is a strong interest from the market and a strong support by the Governments to create a new “asset class” represented by the infrastructure and, more generally, by the long-term investments, it will mean that some

18 The European Data Warehouse (ED), for example, provides information on ABS loans and ratings in Europe. The ED was created in 2012 in line with the Euro-system ABS Loan Level criteria and became fully operational at the start of 2013. It was founded and is owned by a group of major European banks and financial institutions. The ECB and the National Central Banks have attended the meetings of the Board of the ED since the start, as observers. The data pertain to the 29 Member States, reclassified so as to be homogeneous and comparable.

major changes are inevitable. Regarding IAS in relation to the business model and the mark to market philosophy, the subject is under the scrutiny of the FSB after the G20 of Saint Petersburg; however the road seems to be now rather “uphill”.

The introduction of tax incentives may be justified, especially in those cases in which the taxes can be used to correct externalities that come from market failures, as in the case of project finance. Corporate taxes in most countries tend to favour debt to risk capital, thus creating generally higher incentive leverage ratios. Interest rates are, in fact, deductible, while returns from capital are not. Financial deleveraging should be an important goal of the governments’ economic policy. Moreover, tax incentives may encourage PPP. On the one hand, in fact, they make it possible to make investments which would not otherwise have been made because they needed public resources; on the other hand these investments contribute positively to growth and thus to fiscal consolidation. It is an incontrovertible fact, at least in all those cases in which the incentive is strictly directed to re-balance the financial plan of work which had suffered an adverse effect from the cancellation of subsidies or an increase in the cost of bank loans. It must be limited to that higher portion of taxes collected, generated from investment, net of substitution factors. It should not be forgotten, finally, that we must avoid the tax incentive contributing to distort the risk assessment.

The reduction of risks and regulatory costs. Political and legislative stability, streamlined and fast administrative procedures, regulatory and bureaucratic burdens contained, a fast and reliable judicial system, an efficient and technically prepared public administration are known to be decisive factors in investment decisions, which today have the entire globe as their horizon. In the European administrative space, which has finally found a legal basis in the Treaty of Lisbon, it is now possible to envisage a European better regulation policy, looking to ensure the convergence of European and national regulations towards investment-friendly models.

*The Juncker Plan*¹⁹

The Juncker Plan represents a change in the economic (and investment) policy of the EU. Alongside with the two Communications on Flexibility and on State Aid Modernization the general framework has been partially revised. New principles have been

19 Cfr. Bassanini F. The Juncker Plan, cit.; F. Bassanini, Finanziare le infrastrutture in Europa. Piano Juncker, Golden Rule e il ruolo delle National Promotional Banks, Introductory report at the Conference on Innovative Infrastructures for Growth, organised by the Italian Presidency of the European Union and European Parliament, Brussels, 3 December 2014 (now see below, pp. 101-111); F. Bassanini, The Juncker Plan: conditions and requirements to prevent its failure, The Eurofi High Level Seminar 2015 - Riga - 22, 23 and 24 April 2015; F. Bassanini, New Principles for a Stronger Europe in the Global Economy, Eurofi Magazine, 9,10 and 11 September 2015, Luxembourg; E. Reviglio, La legge di stabilità e le politiche per la crescita con riguardo agli investimenti pubblici ed al partenariato pubblico privato Il Piano Juncker, Testo preparato in occasione del Seminario “La legge di stabilità: le politiche economiche fra diritti costituzionali e diritto europeo”, LUISS/Fondazione Visentini, 17 marzo 2015, Atti in corso di pubblicazione presso la LUISS University Press; E. Reviglio E., Il finanziamento delle infrastrutture: verso un nuovo modello, in Cappellin et al. (ed.), Ripresa degli investimenti, innovazione, città. Una nuova politica industriale per la crescita, Egea, Milan: 2015; Maserà R. Il Piano Juncker: la sfida del blending di investimenti pubblici e privati in Europa e in Italia. Civiltà

introduced. Such principles are not shaking the foundations of the economic constitution of the Union –they are, however, seeds of potential deeper transformations. The present change is needed both to promote a stronger EU Single Market and to reduce the competitiveness gap of the European economy at the global level.

The Juncker Plan is also an attempt to construct a new European model for the financing of infrastructure and SMEs. Will it work? A lot of people are wondering this.

To better understand the logic that underlies the European choice for infrastructure, a brief comparison with the United States may be useful. In 2009, President Obama launched a plan to stimulate the economy worth over 800 billion dollars²⁰. In October 2014, Obama launched the “Infrastructure Plan” and in February 2015 he announced a further 478 billion dollars for public works such as motorways, bridges and transport²¹. This time it will be financed by an increase in tax on the highest incomes and on businesses. A balanced budget is predicted for 2025.

It should be noted that the US differs from the EU in a number of important aspects: the US has a much less worrying demographics than Europe, thanks to immigration policies that have brought down the current and future average age of the population. The future of welfare spending appears fairly tame: the US in fact has lower social spending than Europe (6% of GDP for health and for pensions, respectively, compared to an EU average of around twice that – according to US government estimates these will increase from the current total of 12% of GDP to 20% in 2080). The US has far higher military spending than the EU, 17% of GDP compared to the EU average of 1.5%, with significant Keynesian effects, above all on technologies as well as on employment (in addition, the US spent 1.400 billion dollars on various military interventions in the period 2001-2011). Their public debt-to-GDP ratio increased from 70% in 2007 to 110% in 2014, while in the EU in the same period, it increased from 59% to 88%). Unlike Europe, the US is a super-power, and this means it can count on the supremacy of the dollar. Finally, even if the US economy has returned to growth, at around 3%, both economic areas might have to live with “moderate” growth in the next few decades. These differences are substantial, and we believe that they have played a major role in

del Lavoro, being published; and Juncker Investment Plan”, Speech at the EIB Conference “Investment Plan for Europe”, Luxembourg 2015.

- 20 The American Recovery and Reinvestment Act (2009), known as the Stimulus or Recovery Act set out works worth 787 billion dollars, subsequently increased to 831 billion, of which 552 billion on infrastructure, education, healthcare, energy, spending on unemployment and other welfare spending, and 288 billion in tax incentives. The priority assigned to the infrastructure investments also met the need to recover the relative competitive handicap of the United States compared to countries with more advanced infrastructure. See F. Bassanini and E. Reviglio, *European Institutions and the Crisis: Investing to Grow and Compete*, English version of a chapter from the ASTRID research report: *Prove di Europa unita. Le istituzioni europee alla prova della crisi*, G. Amato, R. Gualtieri (eds), Passigli Editori: Florence 2013.
- 21 US Treasury Department, *Expanding the Market for Infrastructure Public-Private Partnerships: Alternative Risk and Profit Sharing, Approaches to Align Sponsor and Investor Interests*, Office of Economic Policy, April 2015 ; Id. *Expanding our Nation’s Infrastructure through Innovative Financing*, Office of Economic Policy September, 2014.

the choice of model for financing investments, and for the economy, of the two most important economic areas of the world. The United States, with direct Keynesian interventions, and the EU with the creation of a model aimed at homogenising projects by raising their technical quality to maximise the participation of “patient” long-term capital (“institutional capital” or “institutional investors”).

Before the crisis exploded – from the introduction of the euro – the convergence of interest rates on sovereign debt in the Eurozone was almost perfect. The storm of 2008 broke this perfect situation. Spreads have started to diverge dangerously. The convergence was based on expectations, not on reality (as, in fact, also seems to be the case for the subsequent divergence, so wide and sudden – a sign that the markets are not infallible judges of reality). In the meantime, the European banking system risked collapse. The recession made things even more complicated. What can be done? Europe decided to proceed with a severe and restrictive fiscal policy, applying very rigid rules to the banking system – which actually worsened the problem of credit rationing – but also starting the Banking Union, which will guarantee a more secure future for bank financing of the economy. More recently Europe launched the Capital Markets Union, with the aim of transferring some of the risks from the banks to the institutional investors, bringing the bank-centric European model closer to the market-centric US one. In the meantime, however, growth and investment crashed throughout Europe²².

With the second Barroso Commission, the theme of long-term investments was placed at the centre of the debate. Diagnoses of the causes of the severe shortage of long-term investments began, new European financial instruments were proposed, new regulations promoting long-term investments discussed, major documents drawn up and promises made. But in real terms, very little has been achieved so far. With the Juncker Commission, things are changing. Investment financing is being placed at the centre of its programme, with the start of concrete European economic policies, and with the launch of a sizeable new EU programme. Initially, some have greeted this as a small thing – or even as a sort of “magic trick” which is using 21 billion (of guarantees) to get 315 billion of works started. The reality is different, and we will try to explain why.

Let us start with two considerations. One micro-economic, the other macro-economic. From a micro-economic perspective, only 10% of infrastructure investment in Europe is being provided by project finance²³. The remaining 90% is provided, roughly half and half, by businesses (mainly utilities) and by the public sector. From a macro-economic standpoint, as we have already stated, Europe must think in terms of a long-

22 Private investments alone fell by 400 billion euro in the EU in the period 2008-2014 (Source: Eurostat).

23 G. Inderst, *Private Infrastructure Finance and Investment in Europe*, EIB WP, 2, 3013. Incidentally, it should be noted that the world infrastructure equity market is worth just under 500 billion dollars (Dialogic data, 2013), of which two-thirds in Europe. Considering a mean leverage of 80%, 500 billion of risk capital in project finance is equivalent to approximately 2,500 billion of works financed at world level (2,000 of which debt). Merely as an example, this amount may be compared with the approximately 90,000 billion of assets managed at global level by pension funds, insurance and sovereign funds.

term future based on a considerable ageing society (and therefore increased costs for healthcare and pensions), high public debt, moderate growth rates (or at least, moderate compared to those of the major emerging markets), and accelerating competition, due to momentous changes in the global economy. The long-term macro-economic prospects force us to prepare ourselves in advance, so that we can play the game tomorrow on the global markets with a sustainable European public budget and a stable and strong financial system; but also, with an advanced system of infrastructure – both tangible and intangible – and an industrial system – and here we are thinking above all of SMEs – that can grasp the great opportunities of globalisation. To achieve this aim the model for financing investment and supporting SMEs must be changed. This is Europe's big challenge in this phase of its political and economic history.

But what is this new model? First of all, it is a model which, as we will see, is highly advanced, in both technical and financial terms. A model capable of attracting the wealth of long-term global finance seeking to invest in a substantial, although still minority, share in financial products with underlying infrastructure and other real economy assets. Financial products with non-speculative long-term risk/yield profiles. To do this, the share of investments in project finance and in Public-Private-Partnerships (PPP) must be increased compared to the share of direct public loans. This is the challenge. If we want to be successful a series of policy interventions at various levels is needed.

This new model also contains an important political message. The creation of finance for growth not only for the current generations, but for the future ones too. If pension and life insurance funds invest part of their savings in infrastructure, and in favour of the real economy, they will have contributed to a better world for their children and grandchildren – children and grandchildren from whom future resources were taken in the second half of the last century, through an excessive use of public debt and too-generous pensions.

So the Juncker Plan represents an important step in the creation of a European model for financing investments that relies as little as possible on the public resources. It is based on new principles, and on a new architecture²⁴. The first innovative principle is additivity: the idea that projects that could not be financed without the Plan can be. This represents a true break with the past: “the support of the ESIF where the market fails, or in sub-optimal investment situations that could not have been financed with

24 The initial response from the Commission was the Investment Plan for Europe” (COM(2014) 903), presented on 26 November 2014, which set out an initial allocation of 21 billion, composed of a guarantee of 16 billion from the EU budget (3.3 billion from the Connecting Europe Facility, 2.7 billion from Horizon 2020 and 2 billion from budget reserves) and an EIB commitment of 5 billion euro. Applying to this initial sum the multiplier of 1 to 15 which – according to the Commission – constitutes a prudent estimate compared to the multiplication effects that occurred under the EIB and COSME programmes, the 21 billion to be assigned to a new European strategic investment fund, to be created at the EIB, should mobilise a total of 315 billion over the three year period 2015-2017. Moreover, this sum does not take account of the potential contributions of the National Promotional Banks and the Member States themselves (to which the limitations of the stability and growth pact would not apply).” Hearing of the Parliamentary Budget Office as part of the fact-finding investigation on the Investment Plan for Europe, Commission V Budget - Chamber of Deputies, 25 February 2015.

the normal tools of the EIB, the EIF and the EU". These are projects that typically have a higher risk profile, that become "financeable" thanks to the intervention of the guarantees.

This at least in part resolves the issue of the lack of good projects, mentioned above. Let's be clear, the problem of project quality is a real one, and must be dealt with, but not infrequently people forget that the profitability of infrastructure projects around the world is often increased by a share of financing in the form of grants of public money. This kind of public intervention is justified by the major positive external effects that the infrastructure investments (such as those in innovation, R&D, education and technology) produce for the entire economy of a country. But also because of the positive effects in the medium and long-term that they produce on the public finances as a whole. From a multi-year perspective, which gives the correct importance to the role of the denominator (growth) in the process of fiscal consolidation, investments must be incentivised, provided they can be debt-financed, by recourse to the market. In particular when the financial resources available on the market have particularly low borrowing costs, as at the present time. Something which today is prevented in Europe by the stability pact, and its asphyxiating annual logic. The Juncker Plan helps to overcome these difficulties, making European resources available to improve the bankability of projects and not including in the European Stability Pact the national public resources that countries decide to transfer into the European Fund or into Regional, Thematic or National Platforms. This last innovation is particularly important, and indeed represents the first major application of the Golden Rule in the implementation of the Fiscal Compact²⁵.

The introduction of the new concept will enable: (1) "bottlenecks" to be at least partially overcome, thanks to the creation of a broader pipeline of "bankable" projects; (2) "market failures" to be overcome, increasing the bankability of higher risk projects that currently cannot be financed; (3) the "blending" of national and European resources with private ones to be promoted, so as to permit the creation of sustainable economic-

25 And this at least in part incorporates the proposal we advanced at a conference organised by the Italian Presidency of the European Parliament at the seat of the parliament on 3 December 2014: "It is necessary that the "Golden Rule" that the Juncker Plan proposes to apply to the contributions made by States to the common fund is extended at least to national co-financing of projects that are selected as deserving of the financial facilities specified in the Plan, i.e. they should not be counted in the deficit and in the debt for the purposes of the European Stability Pact. In this case, this would not be the introduction of a Golden Rule for all public investment, but just for those selected as eligible in the context of the Juncker Plan. On the one hand, the traditional objection based on the risk of passing off current expenditure as investment would not be justified; on the other, the consequent attenuation of the fiscal consolidation process established by the stability pact would be temporary and an exception, as the Juncker Plan must be considered an exception, intended to combat the threat of stagnation and deflation with anti-cyclical investments: so there would be a legal basis, with unchanged agreements, in the flexibility clause represented by the reference to "exceptional circumstances" recalled above. The "Golden Rule" actually originated in the United Kingdom, precisely to deal with long phases of recession, which it contributed to combat with undoubted success" (F. Bassanini, *Finanziare le infrastrutture in Europa. Piano Juncker, Golden Rule e il ruolo delle National Promotional Banks*, in *Astrid Rassegna*, no. 21/2014; now see below, pp. 101-111).

financial plans with a “reasonable” lever; (4) the favouring of those member states that have the greatest need of investments, but which due to macro-economic and fiscal and/or other obstacles of a non-financial and regulatory nature have not been able to take off; and (5) the creation of a virtuous imitation process between country systems, gradually standardising and sharing “best practice”.

The second principle is the principle of communication and transparency through the creation of a European platform capable of giving investors detailed information on the projects and platforms, enabling them to assess and familiarise themselves with new projects. The architecture of the Plan is based on a “multi-level” system that should be able to intercept operators and projects indifferent sectors of the European chess board. At the centre, is the Fund composed of a Steering Committee and an Investment Committee. The latter is responsible for assessing single major projects co-financed with the EIB and the “Platforms”. These may be regional, national and/or sector-specific. The architecture allows a broad number of possible combinations that are potentially able to adapt to the differing investment needs present in the EU. Further, it is possible to capitalise on the Platforms that already exist, broadening them if necessary, and/or creating new ones. The recent pilot platforms developed in the last European budget phase, such as the Marguerite Fund, the “Loan Guarantee Instrument for Trans-European Transport Network Projects” (LGTT), the Energy and Efficiency Fund and the Project Bond Initiative, demonstrate that Joint Platforms of this kind can be successful.

Another pillar of the Plan is acknowledging the role that the National Promotional Banks (NPBs) can play in the Plan. The NPBs have said they are willing to mobilise major resources for the public and private investments of the Plan²⁶. Their aim is to ensure that public and private resources are mobilised in the most effective way possible. They have agreed to: co-invest with the EIB; create regional, national and/or sector-specific platforms; provide technical assistance using their local skills at national level; contribute to the definition and identification of a pipeline of bankable national projects. Finally, the Plan will create a technical assistance hub at European level.

The success of the Juncker plan will depend on some general conditions. First of all, some reforms, both national and European, needed to create the right institutional and market framework for financing infrastructure and investing in businesses must be completed. Political and legislative stability, streamlined and fast administrative procedures, lesser regulatory and bureaucratic burdens, a fast and reliable judicial system and an efficient and technically able public administration are known to be decisive factors in investment decisions, which today have the whole word open to them. In many European countries, despite some recent progress, the quality of regulation and the high regulatory risks remain major obstacles to long-term investment. In the European administrative space, which finally found a legal basis in the Treaty of Lisbon, it is now possible to envisage a better European regulation policy, looking to ensure the conver-

26 KfW, CCD, CDP, BGK committed to invest 8 billion euro each, not directly in the fund, but in the Plan's projects and platforms. Spain's ICO committed 1.2 billion euro.

gence of European and national regulations towards investment-friendly models²⁷. The capacity, or, rather the “external limitation” of the Plan in accelerating the reforms is an essential element that characterises the actions of the European Commission.

Numerous sectors are included in the scope of the Plan: strategic transport, energy, education and broadband infrastructures, social and urban infrastructure, R&D, cultural heritage and education, support for SMEs and businesses in general. The range of eligible counterparts is broad: businesses of all sizes, public utility companies, public sector bodies, SMEs and Mid-Caps, National Promotional Banks and Institutions (NB-PBIs) or commercial banks and dedicated platforms.

The risks that the Plan initiatives may take on range from subordinate debt, mezzanine and risk capital to senior debt. The initiatives and transactions supported by ESIF guarantees will have a risk profile that is typically different from those of normal operations financed by the EIB. However, the risk assessment process (including the calculation of the probability of default and of recovery rate) will have to follow the standard criteria, and will quantify the “total absorption risk” of each operation that requests guarantees needed to increase their rating, without, however, putting at risk the stability of the EIB balance sheet, while making eligible projects and operations that would not be “bankable” according to pure market criteria. In the case of risk capital transactions, the EIB will supply direct financing to individual businesses or projects, or loans to equity funds or funds with similar types of risk.

As we have seen, “additivity” is a key concept underlying the Plan. The principle is necessary in order for the ESIF to be able to support those transactions/initiatives that are subject to market failure or in sub-optimal investment situations. The EIB will assess the individual projects, using its standard risk analysis criteria, and will quantify the expected loss of each project. The final calculation will exclude the “first loss”, which will instead be covered by the Fund’s guarantees. Then the EIB’s risk assessment will be classified according to the risk that characterises the operation according to the ESIF, and the guarantee will be issued based on the need to increase the rating so as to make it financially sustainable. The level of credit enhancement will generally be higher than the equivalent limit normally given to the EIB. The limit may change over time.

If, following the principle of additivity, the Juncker Plan’s guarantees must cover market failures, they should not be considered state aid, at least not if they are granted with competitive procedures. The aim is in fact to level the playing field at a global level, to ensure that businesses and transactions funded with project financing and European PPPs can compete globally. The point is still being debated, but it is crucial.

One of the founding ideas of the European Union was the ambition of creating a big single market in which open competition between European businesses would produce innovation, efficiency, productivity and thereby growth and employment, as well as “creative destruction”. For this to happen, the playing field needs to be levelled, so as to build a virtuous competitive convergence among the European economies. To

27 See F. Bassanini, *Finanziare le infrastrutture in Europa. Piano Juncker, Golden Rule e il ruolo delle National Promotional Banks*, in *Astrid Rassegna*, no. 21/2014; now see below, pp. 101-111).

reach this objective, a strict competition guideline was introduced along with a complex set of laws aimed at ensuring that state aid policies do not create improper competitive advantages for the businesses of one or more country, resulting in a playing field that is no longer level.

This aim remains valid. But it has not been achieved. Indeed, we cannot fail to be aware that a business in southern Europe suffers major competitive disadvantages compared to its northern European competitors, in terms of the cost of money, energy and logistics, as well as regulatory, bureaucratic, legal and fiscal costs. The playing field is by no means level, instead, it resembles a major German city at the end of the Second World War, after three years of Allied bombing. Reconsidering the law on the prohibition of state aid should, with the necessary rigorous controls, permit projects aimed at reducing competitive handicaps (and hence aimed at levelling the uneven playing field), while strengthening the ban on works that make the handicaps worse. In the global scenario, the same reasoning should now apply to the EU's interventions, intended to reduce the competitive disadvantages suffered by European businesses compared to their non-European competitors.

To make the single market effective, it is of course necessary for states that have not yet done so to approve and implement the necessary structural reforms (liberalisation of markets, modernisation of government reform of the labour market, etc.). But once again, national reforms, while indispensable, are not enough: the competitive handicaps in the cost of energy and logistics, for example, require major investment in European infrastructure networks and, more generally, effective European energy and infrastructure policies. But the same could be said of fiscal and regulatory harmonisation, no less indispensable to guarantee fair competition on a level playing field.

We need to think of an economic and political Union that is capable of promoting the recovery of growth and competitiveness in Europe, of re-launching investment, leveraging the specificities of the individual economic and legal systems of each nation. In fact, nowadays, on global markets, Europe faces big countries that do not hesitate to use public resources to support growth when necessary, and that do not stop at defining and implementing effective and industrial policies (China, for example, but also the United States, home of the free market). These are countries that have strongly re-launched strategic investment, not only in infrastructure, but also in innovation, R&D, education and technologies, and which, also because of this, have rapidly recovered to pre-crisis with growth rates, while Europe is still in the doldrums. We need to ensure that Europe does not become a Europe of book-keepers, where policy is limited to talking about decimal points, instead of the future of the biggest economic region in the new globalised world, which needs to invest much more in networks, knowledge and social infrastructure, to grow and be competitive.

Conclusions

Eight years have passed since the topic of long-term investment became part of the debate about the crisis and about the failures of the growth model that led to the crisis.

Since then, much progress has been made. Not only in Europe, but throughout the world. The concept of long-term financing of the economy is on the agenda of governments, large international organisations, national and international regulators, the G20, the market and the European Union. In Europe in particular, the Commission has produced an “Action Plan” which contains the road map for the next European legislature. It contains a series of clear directions. As mentioned above, on some there is broad agreement, on others less consensus. Some technically easier, others harder. In general, however, the market, the banks and businesses are on the starting line and pushing for many of the proposed initiatives to actually become operational. Governments and the EU are aware of this and recognise its urgency. Let us hope it works this time.

Long-Term investing for Europe: solutions from the insurance industry

Bernard Spitz

As the first shoots of growth appear here and there in Europe, France and Italy still face major challenges. Their growth, by all measurements, is still flatlining. European Union figures show that Italy's economy actually contracted in 2014, at -0,4%, while France grew by a measly 0.4%. Meanwhile, both countries face a heavy debt burden: 95% of GDP for France, and a worrisome 135% for Italy.

The European Parliament has recently pointed out that the EU as a whole suffers from a considerable investment gap. Much-needed investments in transport, energy and digital infrastructure have been estimated at €2,000 billion; the European industrial base has fallen to 14% of the EU's GDP. Last but not least, 25 million people — 7 million more than in 2008! — are unemployed.

As long as Europe keeps facing this huge investment deficit, finding herself at risk of a new “secular stagnation”, our top priority is to work at reviving our economy through investment. European industry, in order to create jobs and find its place as the first provider of high value-added goods and technologies, must constantly challenge, transform and modernise itself. Our continent must confront game-changing transformations such as the energy transition, the digital revolution and the indispensable adaptation to climate change.

This requires that every effort should be pursued to facilitate the financing of the European economy and its companies. This applies doubly to countries like France and Italy, who stand in the first battalions but no longer in the first rank of European economic development. We all know the three chief drivers for growth: consumption, exports and investment. Yet our current budget deficits make it impossible to boost consumption by incurring yet more debt. Exporting, even helped by a low Euro, is not enough, especially in the case of France. The only solution remaining to France as well as to Italy is the active promotion of long-term investment.

This is easily said than done, and requires two key decisions. At the domestic level, we have to buckle down and actually reduce public spending. At the European level, it falls to us to work unswervingly in order to ensure the necessary consistency between regulation and national policies favouring investment.

In recent years, in France as well as in Italy, the attention of the national and European authorities has been drawn to the dangers for investment constituted by inad-

equate regulations, most notably thanks to the 2012 French-Italian Manifesto For Long-Term Savings; but also with the 2013 Green Paper On Long-Term Investment in 2013, as well as with the Solvency II Implementation negotiations, which ended by late 2014.

The political will expressed on these occasions must translate, as soon as possible, into suitable regulation to allow for higher investment in the productive economy: into SMEs and ETIs, into major infrastructure projects as well as into initiatives toward the energy transition. The new Commission has clearly put these issues at the forefront of its priorities. Recent initiatives demonstrate a willingness to look for rapid answers to deal with the emergency.

The Investment Plan for Europe aims to constitute an appropriate and ambitious response to the continent's investment challenges. Large French-Italian projects such as the Lyon-Turin high-speed rail link; the renovation program for public buildings to make them energy-efficient; the transition to smart grids for the power utilities, shall be able to be financed through the newly-established European Fund for Strategic Investments (SIEF), an efficient and complementary funding partner to institutional investors, allowing efficient risk-sharing, and capable of financing strategic projects.

French and Italian companies welcome the establishment of such a strategic funding mechanism. However, they insist that to function at the required level, the Fund should operate with built-in flexibility and simplicity, both essential to ensure its effectiveness of deployment and maintain investors' trust in this project.

We shall also have to make sure that the resources made available by the Juncker Plan are actually allocated to fund equally projects proposed by French and Italian companies: the conditions for equal treatment between countries and the beneficiary companies are not yet clarified. The quality of such projects will be critical to enable selection and to attract sufficient private investment flows.

It also matters greatly that national financial institutions and National Development Banks should be able to contribute to the European Investment Plan (IEP). In this respect, the guarantees offered by the EIP could usefully be extended to initiatives such as the creation of regional and thematic funds.

Finally, in order for the Plan to succeed in channelling investment to support the real economy, it is preferable — relying on tax incentives for investors — to direct investment to the categories of projects proposed by the Plan Juncker, as provided in paragraph 2 of Article 5 (EU guarantees operating conditions).

Both French and Italian employers' organizations insist that financing tools for innovative European companies should be strengthened, since they are the ones who most of all face a shortfall in investment from European funds. The European Investment Fund could earmark financing resources specifically for venture and development capital.

None of these issues are new to us in the French and Italian insurance industry: we have already led a similar battle at our own level in years past. We have, in particular, striven to adapt the prudential requirements of the Solvency II European Directive: that is, to find a balance between the financial protection of policyholders and maintaining the capacity to finance the economy. This is a required condition for the insurance

sector to be able to support the major investment projects expected by the European Commission, and therefore to join as full team players the concerted push for growth in our zone.

One could in fact argue that the French insurance industry model constitutes a useful case study on how to control and strengthen insurers' role in a country's long-term investment. In the last two years, the industry has made a concerted and significant effort, which has produced results.

Insurers play an already considerable role in supporting of businesses through investment, and their share is steadily growing. In France, out of €2,105 Bn total investments, €1,220 Bn went to finance businesses in 2014. €50 Bn of these went to SMEs and mid-caps. This addresses both a determination to diversify their allocation and to seek financial performance for their policyholders.

In private equity, insurers invested over €20 Bn in unlisted companies' equity. To reinforce their stake in the small and midcaps markets, insurers created specific vehicles, such as the 2012 NOVA Fund to revive the listing of SMEs & mid-cap companies in Paris. Similarly, in the unlisted bond debt market, the insurance industry launched the €1 Bn NOVO fund in 2013. Finally, the insurance industry contributes to the development of a standardised framework for private placements of corporate debts; this approach led to the development of the "Euro PP" Charter and is now conveyed at the European level by the International Capital Market Association (ICMA).

In short, through "loan funds to the economy," and the "Euro PP", France stands at the forefront in Europe.

I should stress, because it can naturally enough be a concern elsewhere, that these innovations took as a given of one key condition: that life insurance taxation should remain stable. It was, for a moment, threatened; but our government was wise enough to realise that any reform of life insurance should reassure savers, not be a cause for concern. This was the reason for the creation of Eurocroissance.

But Italy has led quite comparable initiatives. The "Destinazione Italia Decree" of December 2013 provides Italian insurers with the possibility to invest in SMEs' bond securities ("Minibonds") and in direct loans. This decree also provided for flexibility regarding the securitization market. With the same objective of facilitating the financing of companies, and particularly of SMEs, by long-term investors. An ongoing reform also deals with the renegotiation of the term of guaranteed products, accounting for most of the Italian life insurance contracts, like the reform of the "Euro-croissance" contracts in France.

One should find it particularly significant that a few weeks apart, almost the same reforms took place on both sides of Alps: it perfectly illustrates the similarities between France and Italy. This only goes to illustrate, at the European level, the need to establish a real policy in favour of long-term investment by the insurance industry, which is perhaps uniquely characterized by its long view and primary need for stability.

It should come as no surprise that French and Italian companies both favour a greater integration of financing and savings flows between France and Italy. (This integration could take place through European funds possessing a "European passport" allowing

them to invest regardless of country, aided by the convergence of regulatory frameworks applying to business financing tools.)

The Juncker Plan, in effect, needs to rely essentially on the contribution of private investors to finance such key areas as the digital revolution, the energy transition, the changing patterns of production and consumption, etc. If we look at the Plan's envelope, out of the €315 Bn worth of investment funds, over €250 Bn must be brought to the table by private investors in the form of co-investment.

It will never be stressed enough: insurers are the champions of long-term investment in Europe. They are the obvious and natural partners for any EU investment policy. With €8,500 Bn of combined assets in Europe, including over €2,000 Bn in France, insurers are the largest institutional investor on our continent, far ahead of pension funds (€4,000 Bn in Europe in 2013) and sovereign funds (€500 Bn).

How disconcerting, then, to see a complete mismatch between Europe's political priorities and Europe's economic regulation. Political leaders may say that their priorities are long-term investment, SMEs and infrastructure. Yet, at the same time, regulation penalizes long-term investment, SMEs and infrastructure. This simply can't work, and this is the reason why we are calling for a reduction of the capital requirements in private equity, securitisation, and infrastructures.

The European Commission has already lowered requirements for high-quality securitisation tranches and for venture capital, but these adjustments are insufficient. We must go further by aiming all the high-quality securitisations and the other segments of investment. It is urgent for the three institutions (the European Parliament, the Council and the Commission) to retain calibrations in the level 2 text which maximize the room for manoeuvre allowed by the Directive so as to favour the productive economy. This, of course, while remaining in accordance with the implementation of the Solvency II schedule.

Increasingly, the desirable outcome is shown to be a union of capital markets. The 2013 Green Paper on the financing of the European economy had allowed the Commission to identify obstacles to the mobilization of project finance. It promote short-term initiatives to unlock funding. Among short-term priorities, we believe that the 2015 Green Paper on the Capital Markets Union should focus on ensuring the conditions for a quality securitization market and also address the key issue of the re-calibration of long-term assets, in particular infrastructure.

We also believe that the Commission has no option but to actively pursue its work and to make it an essential priority, in order to provide answers to the economy's real financing needs. Not only should a quality securitization be developed, but an appropriate prudential framework should be created to permit institutional investors to play their full and natural role as long-term financiers.

Beyond such recent national initiatives, already mentioned, as France's Euro PP Charter and Italy's projected "mini-bonds" to boost SME financing, more creativity is needed to follow through and amplify this movement. National and European deployment of these and similar future initiatives requires removing obstacles (legislative, fiscal,

regulatory and prudential) likely to constrain and limit investments to be made in the economy and infrastructure.

Despite repeated requests from the financial profession to ease the processing of long-term investments such as infrastructure, SME, ETI and securitization, the Commission chose to limit its action to the review of certain types of securitization only. The industry strongly wishes to resume a dialogue with the European authorities in order to improve the calibration of prudential long-term assets, whether in infrastructure, businesses, equity, debt, invested directly or through specific investment or securitized vehicles.

In short, our hope is that the European Union will refrain from any regulatory initiative that would have a negative impact on the financing of the economy. This for a very simple reason: we are the only durable solution to our continent's problems. Joint efforts undertaken under the umbrella of a wise regulation will in effect start a virtuous circle; and rebuild trust between the champions of investment and progress like Germany, and the rest of those European nations committed to economic reform. Only at this price shall we be able to work as a team to create the new European dynamic and provide a future for our young generations.

Investing in Long-Term Europe

Philippe Herzog

The seriousness of the situation cannot be underestimated. Europe, and more specifically the Eurozone, is engulfed in a low pressure economic balance, and there is a risk that this state of stagnation will last. Our societies are not looking to the future. Investors are risk-averse. Human and productive investment has slowed.

A primary analysis highlights the negative effects of (one could even say the absence of) the macro-economic policy adopted in 2008. In contrast to the USA which increased public investment in 2009 to assist the recovery and restructuring of their banks, the policy adopted in the Eurozone prioritized budgetary consolidation and delayed bank restructuring which stalled demand and hindered debt reduction. The ratio of private-sector debt to GDP has not decreased and public debt has risen by 26%.

A secondary, deeper, analysis highlights the fact that the growth model during the years 1982-2008 is in terminal decline in the context of financial globalisation. This model resulted in the rise in both private and public debt, specifically with regard to social compensation as the debt has been transferred to future generations. We cannot reverse this trend without a new social commitment and a view to sustainable development calling for structural changes based on a new complementarity of public and private roles.

The impetus must be investment in skills, infrastructure and industries which will satisfy the needs of the younger generations in the next ten, twenty, thirty years and stem the pauperisation of the middle class while allowing the elderly to maintain decent living conditions. It is a societal choice that must be defined and shared: a new social compact, new industries, a redefinition of European comparative advantages within global competition. This calls for a public investment policy large enough to address the demand and time horizons of investors, thus sustaining the resumption of private investment. Let's take stock of the task: public investment in Europe has decreased by half in 25 years.

Some political leaders recognise this need. The Juncker plan marks a significant change and thus must be supported. It is easy to point out its failures and ambiguities. For example, the Member States did not want to mobilize the European budget – everything in the 16 billion is in the form of safeguards. The desired effect to attract private investment therefore requires a proactive approach. We must also further question the choice and eligibility of publicly-financed projects. Each Member State has its own national responsibility and the specific role of the EU must be clarified. Large member

states are able to undertake any risk they chose in a renewed budgetary framework by reforming their governance. But other Member States are not able to do so which means a level of cohesion and solidarity is required at the Community level. We must also identify mutually-beneficial cross-border projects, particularly with regard to the digital world, professional training and infrastructure... we must do all we can to consolidate the implementation of the Juncker Plan, a first step with an immediate effect, by finding ways to overcome foreseeable barriers and encouraging a coherent and dynamic European strategy. Pessimism kills hope. Ignoring problems only discourages good will.

I propose six framework recommendations which form a whole:

1. Consolidate and sustain political will in the next few months: we propose including long-term investment in Europe into the European Semester.

We know this requires the consolidation of public finances. Balancing this objective with commitments for future investments would be advantageous – making this issue visible at a national level; no longer sacrificing such investments; increase both demand and potential for growth; stem the huge divergence of the economic paths between the strongest and weakest countries by joining forces.

The selection criteria for EU funded investments should be clarified in the Semester procedure. The task force methodology outlined in the Juncker Plan is in fact a black box! We could establish a separate chapter in the EU budget to highlight the safeguards and related projects; we could modify the current indicators which do not allow for the accurate determination of the multiplier effects of investments; redefine the non-harmonised principal of a public investment floor across Member States so as to increase investment. Priority investments will be placed outside of the criteria envisaged in the Stability Pact with a view to the regular reduction of public debt. Eurostat rules that attribute total investments to the annual deficit will also be revised. A European budgetary council will be tasked with working to clarify the details of a well-supervised “Golden Rule”.

2. Establish regular dialogue between project leaders and financiers at the Commission's initiative

Current EU governance suffers from a lack of dialogue between the institutions, companies and investors. This severely damages the promotion of and confidence in projects. The causes of risk aversion have not been seriously examined. Neither has the genuine bottleneck which impedes infrastructure investment. In many Member States, SMEs are not supported and the quality of their projects are not correctly valued, and large corporate projects do not prioritize the European economic area. We propose establishing a European investor forum, bringing together companies and financiers. This must be at the Commission's initiative and the Commission must better understand the nature of the projects and queries from economic players. This dialogue could also be decentralised in Member States – it would reduce risk-aversion and help leverage financing and help expected growth rates multipliers.

3. The valuation and selection of leveraged projects and cohesion on a european scale require programming in strategic focus areas based on market incentives.

Currently these two conditions remain separate. The EU has only attempted to formulate a strategy in the energy sector to address climate change but this has proven largely a failure since the investment bubble in renewables burst in 2011, investment has dwindled. With regard to the digital revolution, the EU has no strategy – setting up broadband everywhere for consumers will not produce economic growth capability – companies have not yet come to grips with digital tools. Both the private and public sector should be trained and supported by creating infrastructures to collect and manage data so as to establish a collaborative european economy. While European research remains strong, ideas aren't produced or effected through the markets. Innovation that encourages key enabling technologies has broken down. Companies cannot get beyond technological experimentation or develop new industries because the european economic and financial space has not been created: it is Death Valley.

The EU must provide a platform to invest in social services and infrastructure. There are multiple needs on the ground which must be addressed in the context of considerable current demographic, social and technological changes. All of our national social security systems are in a state of marked obsolescence. Industry and the financing of the social services must be considered when building innovative forms of cooperation at both the local and regional level. An enhanced Juncker Plan will need to address these challenges.

We consistently hear complaints about lack of skills and expertise while at the same time vocational and continuing training is in a poor state in many countries. We propose developing a European network of Technological Universities, which would be a common infrastructure – key to expanding youth apprenticeship and the requalification of workers still in working life in every region of Europe. Training entails specific risks and characteristics which won't be covered by mechanisms such as the Juncker Plan. The establishment of an investment Fund in human capital is required. In general, each Member State wants to develop its own public investment policy. But the focus of activities in certain countries feeds the decline in other countries. The EU must not be satisfied with establishing general goals but must also set its own priorities and pursue cohesiveness.

Furthermore, unequal access to the opportunities of the Single European Market is striking. The Commission communication on the Juncker Plan also points out that the European market is not spontaneously conducive to investment. Price signals don't work. Establishing carbon price incentives for the decrease in carbon-intensity within the economy, a European Framework for PPP infrastructures, harmonising corporate and savings tax, distinguishing between the social economic value of investments and the short-term financial value of the markets are imperatives. And the bedrock of the current market is deeply lacking in both soft and physical infrastructures that can bring about dynamic cooperation between regional clusters, and networks for the industrial value-added chains.

Jean-Claude Juncker transformed the BEPA into a European Council of strategic policy – which is interesting but not sufficient. We propose establishing a public agency for the development of valuation criteria and the selection of priority investments.

4. Channelling funds towards investment

Today's financing offers do not meet the needs of future investments or project sponsors. Money is plentiful but risk-aversion among investors is widespread. Funding is not the only problem. The larger problem is the lack of working venture capital in the real economy and the high-cost risk. Public investment must therefore set an example – the budget must bear the primary risk. Providing safeguards for investors is a good approach but they must be properly tailored. Direct funding is also necessary.

The problem with the current stagnation is that it is non-cooperative! Investments must be co-financed. Pooling available resources at the Community level is hampered by the Member States. A review of the budgetary programme is planned in 2015 and the fight for pooling and sharing is crucial to the multiplier effect and leveraging. The European budget must have its own resources as soon as possible.

We must of course also question the capacity and willingness of the European financial sector to accept the risks and reduced costs as a result of sharing. Banks must continue to provide loans after which insurers, pension funds and other institutional investments entrusted with the savings of the public will take over. They must expand European credit and equity funds.

However, the entire financial industry complains about the prudential regulatory framework and it indeed discourages long-term investment. The EU has conducted a large and essential stabilization and banking and finance control operation but the prudential rules must be recalibrated and we must gain control over accounting standards. Retirement funds must also be shifted towards long-term commitments in the economy. If we fail to make such changes, investment financing will return to shadow banking which has proven not to be suitable for this role. Furthermore, there is no level playing field with regard to financing, the fracturing of the financial services market is severe and the informational asymmetries are enormous. The banking union and capital market union will only succeed if access to risk capital is available throughout Europe. In order to do this, financial norms and legal and tax frameworks must also be harmonised throughout Europe. New asset classes on newly organized and regulated markets must also be established. The role of institutional investors, long-term savings managers and wealth managers has expanded considerably. They will take over from banks in innovation cycles. The creation of these asset classes and infrastructure PPP finance markets and the securitization of SMEs are priorities. Ranking projects on the basis of their quality, establishing project pools, developing a single European information system are all envisaged. But elected political leaders must understand the urgency.

5. Develop cooperation to substantially improve EU institutional governance

The Commission sets out that the Juncker Plan is based on three pillars: encourage financing by the establishing a EFSI, set up a transparent pipeline of quality projects, improve the environment for investment. Each of these pillars is fragile. Each is ambiguous and they must not be dealt with separately but in conjunction.

I won't revisit the question of establishing a favourable environment – it refers to a large market with rules. EU commitment is too vague.

With regard to the pipeline and selection of projects, everything is run through the Member States who choose their own projects. The main driving forces have been bypassed – the project leaders themselves, companies, clusters, PPP project companies, local and regional authorities. The bottom up principle and cross-border cooperation don't work. It is therefore important to include the Regions in the European semester and establish a forum for business and finance players. The EIB will then manage the EFSI. It certainly has the capability and experience to do so but clearly is not sufficiently committed to the Juncker Plan (it will only fund 63 billion of the expected 315) and the Commission is relying too heavily on leveraging. What was the point of establishing a EFSI if not to shoulder the risk that the EIB does not want to bear alone? Lack of cooperation weakens these governance systems.

One doesn't need to use the pool of project directors to satisfy the EU interest and it is important that the Structural Funds are not used. Interregional and cross-border cooperation is minimal. Public investment banks or other National Promotional Banks (NBP) which are large savings providers and incorporate equity and loans are not solicited by the EU. If they are not directly involved, the plan may never get off the ground. The members of the long-term investors Club want to cooperate and have concerns that need to be addressed. Either they enter into the process or they will establish their own European Long-Term Investment Fund (ELTIF), with far too little support.

A cooperative spirit could be encouraged in working towards a Eurosystem of investment financing. For that purpose, we propose recapitalising the European Investment Fund (EIF) from the European budget and drawing heavily on private investors and on NBP) which are subsequently to become its principal shareholders. The EIF must deal with the EFSI whose governance is opaque and cut off from investors; it will become a keystone fund for the promotion of regional and national funds.

6. Investment is a collective commitment which can not reach the European level without the involvement of citizens and financial players.

The Commission and Parliament, local and national authorities, media education and education systems and civil societies must initiate and inform a public dialogue for the future Europe. To kickstart social dialogue, a European system of socio-industrial relations must be established which revolves around training, employment, creation and production.

People of goodwill are cognisant of the need for urgent action but are doubtful of the political will to act. Mobilising all actors seeking to assist in the promotion of a vi-

sion of Europe will extend time horizons for projects and create confidence in an EU threatened by the outbreak of situations and divergences. The potential exists in our societies. Using available surveys, Maurizio Cotta showed at our annual conference in Brussels that the crisis has not yet weakened a prevailing feeling in Europe that belonging to the EU is a good thing. But pessimism is building. While 83% of Germans are happy with their circumstances, only 4% of Spaniards feel the same, 5% of Italians and 8% of French. Support for pro-European leadership is too weak while several national parties are getting organised in developing anti-European leadership. Representative democracy is facing challenges everywhere and public confidence in national parties and elected representatives is very low. At the same time, the ever-increasing desire to participate and deliberate offers potential for renewal. In order to take advantage of this, investment for the future is an essential test not to be missed. We are right to approach political leaders and get them to listen.

Long-Term investment is vital for Europe

Philippe Legrain

Long-term investment is vital for Europe. It's a bridge between the present and a brighter future. It can re-energise our economies today, while building stronger economies for tomorrow. It is a springboard out of the crisis and a solution to secular stagnation. And while it's an investment for the long-term, it is needed urgently, right now.

Because seven years after the first bank in Europe failed and was bailed out by the German government, the eurozone is still stuck in a balance-sheet recession, with zombie banks, a big overhang of private-sector debt and a huge shortfall of demand. Households, companies and banks are all trying to repair their balance sheets at once – and instead of accommodating the private sector's desire to save more by borrowing more themselves, or accelerating the balance-sheet repair by restructuring debts, governments are compounding the problem by trying to borrow less too. So the economy is stagnating, private-sector debts have barely fallen, and public debts have soared all the same.

A simplified way of putting it is this. Households aren't spending because their wages are stagnant and they're trying to pay down their debts. Since consumers aren't spending, companies don't want to invest. And governments are cutting back too. So domestic demand is depressed. And since eurozone economies mostly export to each other, each country's depressed domestic demand limits demand for others' exports. Thus the eurozone is relying entirely on demand from the rest of the world in order to grow. But the eurozone is too big and growth elsewhere too weak for that to generate a recovery strong enough to bring down debts and unemployment and encourage private investment.

The eurozone also has severe, longstanding supply-side problems. Over the past decade, productivity growth averaged only 0.9% a year, half that in the United States. On top of that, the eurozone has dismal demography: its working-age population is no higher than in 2008 and has been declining since 2011. But even if we assume the eurozone's potential rate of growth is as little as 1% a year, the economy should still have grown by 7% over the past seven years. Instead it has shrunk by 2%. Clearly, then, the eurozone's biggest immediate problem is deficient demand. So while supply-side reforms to boost productivity are vital for future growth, they're not a substitute for policies to boost demand now – indeed they cannot succeed unless accompanied by measures to fix the banking system and boost investment.

To solve the crisis, we need a whole package of measures, which I discuss in my book, *European Spring: Why Our Economies and Politics are in a Mess – and How to Put Them Right*. And a crucial component is increased investment, which is key to stimulating demand now and achieving sustained long-term growth. Yet a structural decline in investment rates has been compounded by the long slump, with businesses unwilling to invest with demand so weak and governments finding it politically easier to slash public investment than recurring expenses. We need to reverse this.

Look at what financial markets are telling us. With long-term interest rates near-zero, markets are screaming: borrow. And with the cost of capital so low, the number of viable projects is huge. In fact, Europe now has a once-in-a-lifetime opportunity to upgrade its industrial backbone, modernise and diversify its energy grid and build next-generation digital networks, to finally complete the single market in services and energy, and spark a more innovative economy of the future.

It's not just an economic opportunity, it's a political necessity: to show disenchanted citizens that Europe is not just about austerity, recession and constraints on what they can do, but also about how we can all achieve more together. Lasting shared prosperity. Better jobs. More competitive businesses. World-class infrastructure. Energy security.

So while some people say it is irresponsible to borrow and leave our children and grandchildren huge debts, the opposite is true. Failing to invest means incurring unnecessary suffering now and bequeathing a smaller, less advanced economy with lower living standards and worse public finances to younger generations. That would be deeply irresponsible.

How, then, do we deliver the increased long-term investment that Europe so desperately needs? The starting point is investment in public goods that yield a large social return, but not a readily capturable commercial one: education, basic science and research, harnessing digital technologies to deliver innovative public services.

There is a clear-cut case for increased public investment and we need Stability and Growth Pact rules that are flexible enough to distinguish between borrowing for consumption and borrowing to invest. To make the distinction between consumption and investment crystal clear, the EU could shift its fiscal accounting from a cash basis to a balance-sheet basis, as New Zealand does.

Europe also needs long-term investment in projects that yield a commercial return, but which the private sector is unwilling or unable to finance alone. When I was economic adviser to President Barroso, I fought to insert a line into his State of the Union speech in 2011 on the need to increase the capital of the European Investment Bank and in 2012 I pitched the idea to Francois Hollande's advisers when he was still a presidential candidate, and that capital increase became the centrepiece of the Compact on Growth and Jobs that June.

Now we have the Juncker Plan, and there is also a clear case for a further capital increase for the EIB in order to expand its lending for infrastructure, to small and growing businesses and in venture capital, while also expanding the activities of public investment banks at a national level.

There are trillions of dollars of funds worldwide looking to diversify and enhance their returns by investing in infrastructure. Policymakers have a duty to create a coherent framework of regulation and support, as well as a supply of investable projects on attractive terms, that helps mobilise these funds and channels them to productive investment.

There are also trillions of euros of long-term savings here in Europe earning a paltry return, not least in pension funds, that could be better deployed towards productive investment.

All this is a step towards the EU's broader objectives of creating a more diversified financial system: capital markets as well as bank finance, more equity finance as well as debt – a capital-markets union for Europe, and a financial system that serves the needs of the real economy: productive investment not property bubbles.

Above all, we need to rekindle demand in Europe and put people back to work. The time is now. Europe's future is in our hands. We need to have the confidence and the ambition to build it.

The expected evolution in the Eurozone banking system

Federico Arcelli

The EU has undertaken some significant reforms, such as the decision to create common banking supervision and a path to banking union. We are actually starting to see the benefit of such landmark moves.

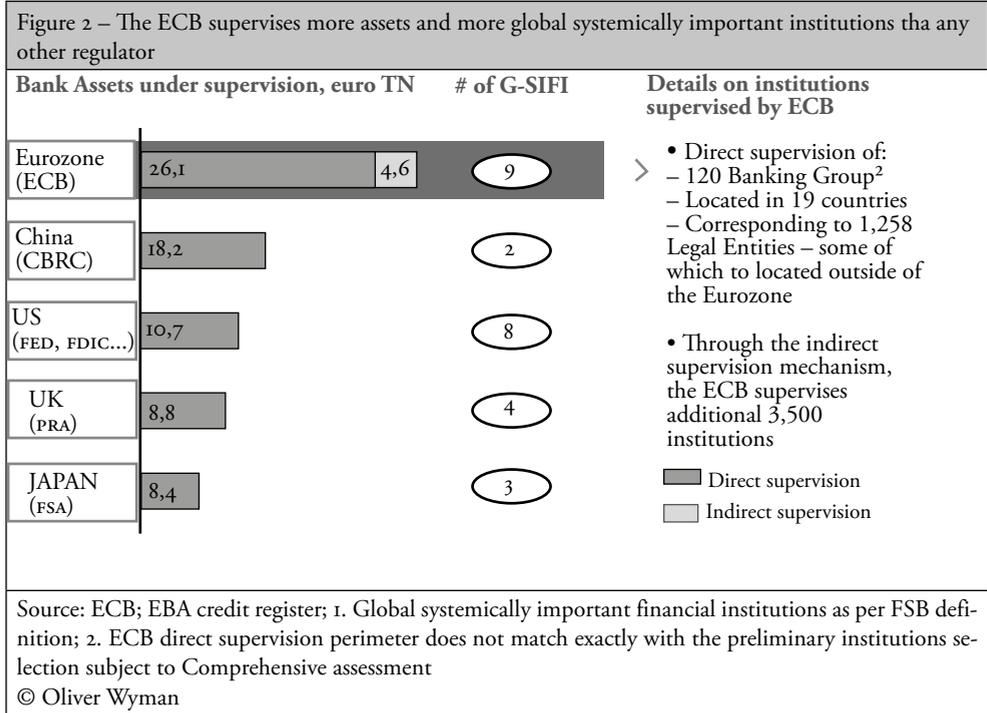
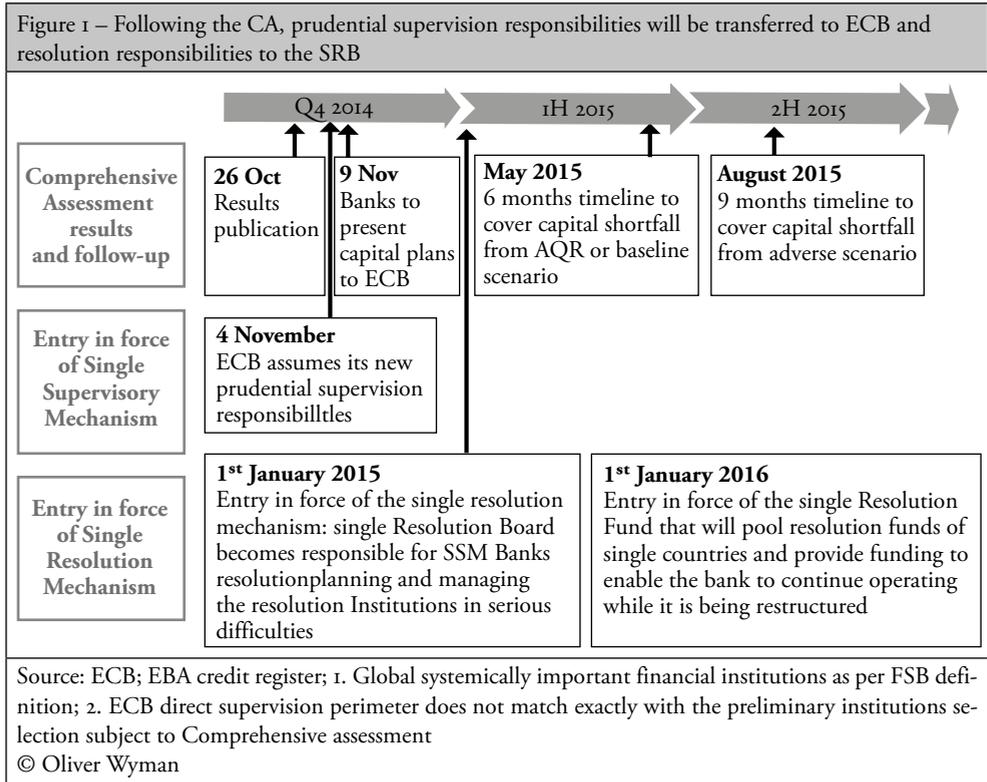
In order to briefly summarize the path for change in the banking sector, we may just quickly recall the main events which already took place or will take place (see Figure 1). In particular, the entry in force of the Single Supervisory Mechanism (SSM), as of November 4th, 2014 and of Single Resolution Mechanism as of January 1st, 2015 in the transitional phase and by January 1st, 2016 in the complete scheme (although the Single Resolution Fund will build up progressively its capacity).

In the new SSM banks will need to respond to the different than the past (at least for sure different by each “old” national tradition of supervision) demands of the joint supervisory team, whilst one can expect that national regulators would likely increase regulatory focus on topics such as conduct risk, although the exact extent of the possible definition of two-layered regulatory system is not yet clear nor the only possible outcome.

All the changes which have been designed and are going to be implemented (if not already in place) will be paired with an increased stress on a new way to interpret supervision and the role for the central bank. In few words a new governance model which is going to change the relation between supervisor and supervised entities, insisting on a stronger role of the board of directors and of the internal governing bodies of each bank, as a kind of cooperative framework which entails both higher responsibilities for supervised entities but, also, likely, a better relation which means, in the end, to pave the way of the application in Europe of the same rules in an effective level playing field.

For sure banks will be required to upgrade their capabilities, and not to interact with supervisors just in the form of being “compliant” with requirements, but also to be in condition to contribute to a dialogue which will assess a global view of their business.

On the other hand, ECB will become (see Figure 2), the leading supervisor in the world in terms of responsibilities (in example number of systemic institutions under supervision) and likely the one managing the more complex architecture, as in the context of the Eurosystem ECB relies upon all the member national central banks.



Banks will need for sure to consider and enhance their scenario planning and enhanced stress testing capabilities, as well as possibly upgrade data infrastructure and management. In fact, in example, RWA calculation methodologies will be core to feed strategic planning and long-term perspective of their business and needed for the assessment of current capital need and profit ratios, but also for perspective plans.

Markets will price these capabilities and supervisors will need to interact with informed bodies. But how many of the over 120 banks under ECB supervision are in condition to cope effectively with such needs?

While all this may prevent the next crisis, and it is for sure facilitating the exit from the last one, it has come also as a possible significant burden for the whole banking system in order to cope with all the needs of the new supervisory landscape. In particular, banks are called to a strategic and tactical reshaping, and in the recent past and the next months we saw and will be seeing several likely developments in the markets.

- The first step (mainly last year) consisted in several capital raising or capital optimization operations, as a result several concurrent regulatory developments – in particular the eligibility of capital instruments for fully loaded Basel III capital ratios.
- The possible immediate next step, already ongoing, and possibly already factored in by markets, is the recognition of the results of last year comprehensive assessment in underwriting standards, provisioning, pricing (assets and liabilities) and capital allocation.
- What it is expected to be the next step is a wave of consolidation and divestments, especially in countries which are the most affected by crisis conditions.

Each of the above topics may need specific discussions about the expected outcomes and what will happen on the market and in the economy. But the clear focus on risk and capital management of the new system will possibly benefit the markets with more and better quality information.

One can also expect widespread further efforts on NPL management issues, as capital consuming items on the asset side will be an obvious first target for management, although the way these actions will be performed may vary substantially depending by jurisdiction, legal system in place, market liquidity and quality of information.

Globally, the expectation for the forthcoming months and years is that Europe will have a gradually more cohesed and efficient banking system, which will be operating in a structurally more level playing field with markets more and more in condition to function effectively. All this may not be enough for ensuring that the real economy will start again growing significantly, as a lot will depend by policymaker's decisions, but certainly a significant leap towards a more unified Europe will have been made.

Infrastructure as a global asset class

Sara Bonesteel

The world faces a substantial and growing need for infrastructure – and therefore for infrastructure investment and financing. One way to address the need for more infrastructure investing is to make infrastructure more accessible to investors – in other words, to define it as an asset class, with the analytics, transparency, and common understanding among investors that such characterization implies. But is it possible to define infrastructure as an asset class?

Prudential Financial, Inc. (PFI)'s businesses have been large providers of long-term capital to a range of infrastructure programs for many years. Its private lending business, Prudential Capital Group (PCG), manages an infrastructure portfolio of more than \$9 billion for the company's insurance portfolios (as of December 2014). The PCG team focuses on investment grade debt and invests in energy infrastructure as well as the transport, social and water sectors. In 2012, Prudential Capital Group, which also operates as Pricoa Capital Group in Europe and the U.K., created a dedicated infrastructure team to source opportunities globally and in multiple currencies. In the public markets, Prudential Fixed Income, known as Pramerica Fixed Income in Europe and the U.K., holds a substantial amount of infrastructure related public debt for PFI's portfolios. In addition, PFI participates in infrastructure equity through our alternatives investing.

Is infrastructure an asset class?

No single definition of "infrastructure" exists within the investment community, and assets included across various definitions can range from "greenfield" public works projects to public corporate bonds in telecom or energy sectors. In general, infrastructure investments run across several traditional industry sectors and disciplines (e.g., energy, power, transportation, telecommunications, ports, social housing) and instead is distinguished by several principal characteristics.

First and foremost, investors tend to think of infrastructure as a long duration asset class, and as such it suits investors with long-term investment needs. Other characteristics commonly cited, beyond the ultimate use of the asset/project itself, include: illiquidity, often manifested in long investment/draw periods, or, if debt, a lack of rating; complexity, requiring specialized skills to analyze; and uniqueness, having few closely comparable investments to which to compare structure, assumptions, or returns. Taken

together, these characteristics – along with the types of investors they tend to attract – might add up to an “asset class.”

Why infrastructure assets have a place in long-term investors' portfolios

Infrastructure investment may provide unique benefits to long-term investors' portfolios. First, infrastructure can provide diversification. The supply of long-term assets (other than sovereign bonds) is relatively constrained and is in high demand. Infrastructure debt from new issuers, whether governmental, quasi governmental, or private, represents a new source of investment opportunity which allows investors to better diversify their portfolios. Infrastructure debt, by its very nature, tends not to be highly correlated with other investments in an insurer's or pension fund's portfolio. Few other asset classes (other than sovereigns) are able to offer a diverse supply of high credit quality, long-duration assets.

Second, infrastructure has the ability to bring stability, in cashflow and in credit performance. Historical rating agency default and recovery data indicates that infrastructure investing has lower risk than corporate lending.⁽²⁾ While risk can be high during the planning, permitting and construction phases of some projects, operating risk can stabilize or improve over time as the project goes into production – when long-term investors like insurers and pension funds can play a role. Infrastructure projects tend to have stable cash flows due to regulated revenue models which help to support the credit over time. This is unlike typical corporate credit where risks increase with duration.

Obstacles and challenges to infrastructure investing

From the investor's perspective, the features that characterize infrastructure – its long-term nature, illiquidity, complexity, uniqueness – tend to make infrastructure challenging to analyze. A variety of efforts could be made to make infrastructure attractive to investors, including standardization of documentation, improved access to information and analytics about investment performance, and creating structures in which investors of varying risk appetites can find suitable investments across the risk spectrum.

Perhaps more important, though, investors often cite a lack of investment opportunities as a reason they are not more invested in infrastructure. Greater assurance of a “pipeline” of opportunities from project sponsors would also attract investors to the asset class. The further development of Private Public Partnerships globally may prove to be a powerful vehicle for creating that pipeline and recycling proceeds from existing societal assets into new productive assets.

Finally, regulatory frameworks around the world must acknowledge the long-term investment needs of their regulated entities and appropriateness of good quality infrastructure investments to meet those needs. We believe that new regulatory frameworks for banks and insurance companies create disincentives to long-term investing. For banks, Basel III constraints that aim to ensure short-term resilience to potential liquidity disruptions penalizes illiquidity and maturity transformation by levying high capital charges on less liquid long-term investments. In Europe, Solvency II applies sig-

nificantly higher capital charges to longer-term and mid-investment grade assets such as infrastructure debt. G-SII, Dodd-Frank and other macro prudential regulation to date has favored shorter-duration, more liquid assets in a financial institution's investment portfolio. Unfortunately, these regulations penalize these very types of assets and may instead be incentivizing greater spread reinvestment risk for insurance companies. In order to promote infrastructure investment, capital charges should reflect the lower risk profile of infrastructure relative to corporate credit over the long-term.

In summary

We believe that infrastructure investment is not only important to society, but also strategically important for long-term investors, and PFI has had a longstanding commitment to infrastructure as a result. Indeed, we welcome the opportunity to help develop infrastructure into a recognized asset class among long-term investors. Better access to information for investors, a more assured supply of infrastructure investment opportunities, and greater understanding among regulators of the important role infrastructure investments play in long-term investors' portfolios, will enable infrastructure as an asset class to flourish.

Financing Infrastructure in Europe. The Juncker Plan and the role of the National Promotional Banks¹

Franco Bassanini, Edoardo Reviglio

1. Something is changing in European economic policy. After six years of austerity and restrictive fiscal policies we have the Juncker Plan. Too little too late? Perhaps. But if this is the start of a new European policy for growth, we can at least consider it a good sign. The sign of a change which is largely due to the commitment of the Italian Presidency of the EU, which, in recent months, has endeavoured to promote a new expansionary policy after years of stagnation and recession.

We are surely still a long way off from what we really need in order to change direction. In 2009, the US pumped more than 900 billion dollars, in various forms, into the economy in order to boost investments and growth. This involved additional resources – public funds for infrastructures and research, fiscal incentives for infrastructures, climate change and businesses, guarantee systems and a Project Bond plan with fiscal incentives of more than 200 billion in only two years, and much more besides. Thanks to Obama's Recovery Plan as well, in the US growth and employment returned to pre-crisis levels in a matter of only a few years.

Between 2009 and 2013 Europe experienced one of the longest and deepest recessions in its history, with real growth in the euro area equal to only 0.4% per year. Forecasts for the coming years are anything but reassuring. The cure for this “great depression” has been fiscal consolidation and structural reforms.

Fiscal consolidation is necessary to reduce excessive government debt. But fiscal consolidation without growth is not sustainable over time.

Structural reforms are important and definitely useful. To a great extent, they have already been implemented or launched. But they are also expensive, at least in the early years, and their positive effects are only felt in the medium to long-term. In the short term, they are especially necessary to convince financial markets and investors of the sustainability of Italian government debt over time and the prospects for recovering the country's growth and competitiveness in the medium term. Furthermore, they are a sine

1 Introductory report to the Conference on *Innovative Infrastructures for Growth*, organized by the Italian Presidency of the European Union and by the European Parliament, Brussels, 3 December 2014.

qua non of credibility to be able to open, with some prospect of success, negotiations with European institutions for implementing the flexibility provisions provided for by the European agreements. It is disputed, however, that they are not in themselves sufficient to trigger a recovery during periods of low growth and/or stagnation or prolonged recession. They do not, therefore, replace expansionary policies or especially the revival of investments in the real economy and in infrastructures.

Economic literature – both theoretical and empirical – has amply demonstrated the role of investments, especially those in infrastructure², in stimulating the growth and competitiveness of economic systems. The main studies agree in attributing to investments a positive and significant effect on the potential GDP growth and on the reduction of economic and financial imbalances that characterize some economies. The IMF recently revealed that now is the time, especially for advanced economies, to decisively increase investments, especially in infrastructure.

According to the IMF, increased investments would support the demand in the short-term and would also help to improve the potential GDP in the long-term. The IMF estimates, in a sample of advanced economies, that an increase in expenditure on investments amounting to 1% of the GDP would increase GDP growth by approximately 1.4% in the same year and by 1.5% in the next four years. In the Eurozone it was likewise calculated that every percentage point of higher government spending would have a positive effect on the GDP amounting to approximately 1.42% in the first year and 1.46% in the next five years³, and it is also maintained that the empirical evidence would also show that the multipliers depend on the economic cycle and are more effective in times of recession than in times of growth (see below Natacha Valla, *Investment in Europe needs a new architecture: the Eurosystem of National Promotional Banks*, pp. 112-129).

Similarly to other conditions, it is clear that such an increase in investments would also have positive effects on the dynamics of the debt/GDP and deficit/GDP ratio by a more than proportional increase in the denominator compared with that of the numerator. Investments in infrastructure do not, therefore, only have important economic multipliers but also important “fiscal multipliers”, especially in times of economic downturn, in which they can play an important counter-cyclical role.

- 2 Recently, some American researchers, on studying the riskiness of American banks between 1830 and 1860, have empirically shown how the probability of default and solid equity position of credit institutions was significantly lower for those banks located near to important rail networks. The percentage of banks not located near rail networks that have “failed” was approximately 35% compared with 7% of those that worked “closer” to rail networks. Furthermore, they also showed how, following an infrastructure investment in the rail sector, the stability of banks located in the area pertaining to the investment tended to improve significantly. The authors maintain that rail networks have, on the one hand, supported the profitability of banks by creating a larger market of potential customers and, on the other hand, have reduced overall risk, allowing the same banks to significantly diversify their loan portfolio thanks to the development of growing manufacturing activities.
- 3 “This is significantly more – note Valla (see below, pp. 117-118) – than the multipliers applicable to other fiscal instruments, 1.38 for government consumption, 0.92 for social transfers, 0.55 for VAT cuts, and only 0.37 for employees’ social contributions”.

2. Investments in infrastructure are also significantly important in another respect, crucial for European construction. One of the founding ideas of Europe was the ambition to create a large single market in which free competition between European businesses would produce innovation, efficiency, productivity and therefore growth and employment. In order to do that it was necessary to level the playing field, in order to build a virtuous competitive convergence between European economies. To achieve this goal, strict competition regulations were introduced as well as a complex regulation to prevent State aid policies from creating improper competitive advantages to the benefit of the businesses of one or more countries, thus unlevelling the playing field.

This objective remains valid. But it has not been achieved. It cannot be overlooked that in fact today a company in Southern Europe pays a significant competitive handicap to its competitors in Northern Europe, in terms of costs in money, energy, logistics and even in regulatory, bureaucratic, “judicial” and tax costs. The playing field is far from level, looking more like a large German city at the end of the Second World War, after three years of allied air raids.

The same competition rules and their practical implementation require reflection and review. Since the legislation on the prohibition of State aid, which, in accordance with its initial ratio should not prohibit, but rather encourage, public interventions designed to reduce competitive disadvantages and therefore restore equal conditions between companies competing in global markets. Embarrassing questions also need to be asked such as: are we sure that the guarantors of competition and state aid in Brussels are really independent arbiters capable of dealing with every case using the same criteria? And do national lobbies and those of big businesses really not have any power over the choices of European bureaucrats when making decisions involving competition and state aid?

To make the single market more effective it is of course necessary that the States that have not yet done so approve and implement the necessary structural reforms (liberalization of markets, modernization of the Public Administration, reform of the labour market, etc.). But once again, national reforms, while essential, are not enough: the competitive handicaps in the cost of energy and in logistics, for example, require significant investments in European infrastructure networks and, more generally, effective European energy and infrastructure policies. But just as fiscal and regulatory harmonization is spoken of, it is no less essential to ensure a fair competition on a levelled playing field.

An economic and political union is also worth considering that is capable of promoting the resumption of growth and of European competitiveness, boosting investments, enhancing the specificity of individual economic systems and national legal systems. Europe today is in fact compared, on the global markets, with large countries that do not hesitate to use public resources to support growth when needed and that do not desist from defining and implementing effective industrial and commercial policies (think of China, but also the United States of America, home of the free market). These are countries that have strongly re-launched strategic investments, not only in infrastructure, but also in innovation, R&D, education, and technology and that have, even for this, quickly resumed a rate of growth no less than that of the years prior to the crisis.

Europe, however, is still stranded. The Prime Minister of Italy was right when a few days ago – in front of a group of European parliamentarians – he congratulated himself over the new direction taken by Europe thanks to a more courageous investment policy. But he added a warning that this was only the beginning and much more needed to be done to avoid the risk of becoming a “Europe of accountants where policy is limited to discussing the decimal points of parameters” and not the future of the most important economic region of the new global world which needs much more investment in networks, knowledge and social infrastructures to grow and be competitive.

3. The need for a change in pace, therefore, no longer seems postponed, leading to the definition and implementation of an effective European policy for growth, focusing on actions capable of “directly” activating the aggregate demand and giving scope for the potential recovery of the economic cycle, and especially on investments, primarily investments in infrastructure.

The Monetary Fund, in the latest World Economic Outlook, reported how the time had come to decisively encourage investments (specifically in the sector of infrastructures), including public investments, in order to support aggregate demand.

As previously mentioned, according to the latest estimates of the Fund, an increase in spending on investments of 1% of the GDP would increase the GDP by approximately 1.4% in that year and by 1.5% over the next four years. All things being equal, this would also guarantee positive effects on the debt/GDP and deficit/GDP dynamics through an increase in the denominator that is more than proportional to that of the numerator.

It is now obvious that obsessive attention to the numerator only in debt and deficit ratios over the GDP does not allow ambitious fiscal consolidation plans to be achieved over time. It's time to change direction. To move boldly from Fiscal Compact to Growth Compact, also as a sustainability condition of Fiscal Compact. Besides, the Treaties do allow it. The necessary flexibility instruments are provided for in exceptional economic conditions.

When the European Parliament discussed it, three examples of exceptional circumstances were jointly evoked: recession or prolonged stagnation over a period of time; deflation or inflation well below the target of 2% per annum; exceptional natural disasters. These conditions exist in various European countries. In the case of Italy, all three are present. We are in an exceptional economic situation, which economic historians have shown to be worse than the crisis in the Thirties. And the effects of climate change make the implementation of the plan for overhauling the necessary structures to prevent hydrological risks and natural disasters something that cannot be put off.

Claiming to apply European treaties ignoring the flexibility clauses would be tantamount to applying the criminal code for the crime of murder ignoring the right of self-defence. The application of the flexibility rules provided for in the European treaties is vital for constructing a common route that can get the euro zone out of a “tailspin” situation with regard to choices of budget policies which are particularly anti-cyclical in this phase of the economic situation.

The restrictive reading of the rules on the subject of the lack of flexibility in the application of the treaties can, in actual fact, have contradictory effects. Europe finds itself in the typical Keynesian situation of the so-called liquidity trap. It continues to focus on supply

side policies (which in many countries, Italy included, should have been activated decades ago) when the problem is now demand. The ECB is aware, but it also knows that monetary policy is not enough, especially when rates are close to zero and constraints outside the euro are very strong. Future European Councils will have to address the problem of effective policies to support growth and therefore investments. Otherwise, it will be impossible to avoid certain questions, only apparently challenging: is there an economic logic to increasing national sovereign debts by more than 500 billion to finance the ESM and oppose financial speculation that operates against peripheral countries first and foremost because they are not growing (and are also not growing because of restrictive fiscal policies)? Wouldn't it be better to use these resources to boost the economy or to lower the fiscal burden? Wouldn't it make more sense to give the ECB the powers of the Fed or the Bank of England?

4. The Juncker Plan expects to encourage more than 300 billion of investments, largely financed by private resources. If this is just the beginning, it can only be seen as a turning point. But the resources it is equipped with are, at the moment, very few. It is true that part of the plan consists of guarantees that have important multiplicative factors. But the guarantees are not enough when there are also significant shortcomings on the equity side.

These shortcomings are often underestimated, putting forward the problem of the lack of good projects. The issue with the quality of projects is real, and it is being dealt with, but it is often forgotten that the profitability of infrastructure projects around the world is frequently increased by grants taken from public budgets. This public intervention is justified because of the positive external effects that investments in infrastructure have (such as those in innovation, R&D, education and technology) on a country's entire economy, and also due to the positive effects that they have, in the medium and long-term, on public finance aggregates. With a view to the long-term, in order to restore the proper importance to role of the denominator (growth) in the process of fiscal consolidation, investments should be encouraged, allowing them to be financed by debt, by recourse to the market. Especially when financial resources found on the market have very low financing costs, as in the present circumstance. This is now prevented in Europe by the Stability Pact and its weak annual logic.

If you consider that only 10% of infrastructures in Europe are achieved through project finance and a further 36% are funded by corporates (particularly, but not exclusively, by utilities and high-tech companies), the remaining 54% is still financed by the general tax system. A greater presence of private companies in the private PFI is definitely desirable. It is a vital objective in the medium and long-term. Not only in Europe, but also in the rest of the world. But it is a frontier. It will take time to achieve. And nowadays, time is something that is in short supply. Instead, interventions are needed in investments that are capable of taking off quickly and reaching their potential in growth and employment from the outset.

Therefore it is necessary that the "Golden Rule" which the Juncker Plan proposes to apply to the contributions that the States will pay into the mutual fund, is extended at least to the national co-financing of projects that shall be selected as worthy of using the financial facilities provided by the Plan, in the sense of not counting them in the deficit for the purposes of the European Stability Pact.

It would not, in this case, involve introducing a Golden Rule for all public investments, but only for those selected as eligible under the Juncker Plan. On the one hand, therefore, it would not justify the traditional argument based on the risk of smuggling for current investments expenditures; on the other hand, the subsequent slowing of the path of fiscal consolidation, established by the Stability Pact would occur on temporarily and exceptionally, as Plan must be considered as exceptional, intended to counter threats of stagnation and deflation with counter-cyclical investments: it would therefore find a legal basis, by unchanging treaties, under the flexibility clause represented by the reference to the “exceptional circumstances”, mentioned above. The “Golden Rule” was founded from the rest in the United Kingdom, in order to deal with long recessions, which it helped to counteract with undoubted success.

Alongside, a discussion should also be opened on the role of investments in business infrastructures. If they create approximately 40% of infrastructures in Europe why not have special fiscal instruments or instruments of another sort to facilitate and provide incentives for the large and not so large corporations that make investments in tangible and intangible infrastructures? Why not think about “collateralising” the infrastructures created by businesses for the purpose of securitising them or turning them into covered bonds to be transferred to the capital market? Why not look for new forms of collaboration and blending between PFIs, investments in large corporations and the public (Europe and member states) through new financial instruments and public and public/private guarantees? Why don't the big European businesses that manage energy, transport and networks join forces creating special JVs or “European Joint Businesses” – among other things provided for by European treaties?

5. In the meantime, we need to continue expanding the share of infrastructures created with project finance and with PPP. First of all, it is necessary to define and implement the European policies to promote and support long-term investments, whose need and urgency, emphasized by the Larosière report and by the Monti report, as well as by a dozen communications from the European Commission, is now the subject of an almost unanimous consensus, not followed, however, by any concrete fact.

They form part of these policies:

- a) The definition of an international and European regulatory framework that is more “favourable” to long-term investments. Currently, the main accounting and prudential rules (Basel III-CRD IV, Solvency II, IORP, and IFSR) still tend to favour short-term financial commitments and to penalise long-term investments in infrastructures and in the real economy. CRD IV was approved by the European Parliament. Some improvements were made in favour of SMEs. Some recalibrations (especially with regards to liquidity ratios and capital absorption for certain classes of assets) to favour banks in particular during the construction of works are still needed. Can they only be introduced at a later stage? Perhaps. But let's not forget that we might not have a “later stage”. We must act straight away and decisively. New European legislation should be aware that regulation should return, at least in part and with all the wisdom and prudence required, into the hands of politics. It's not a question of ignoring the need for rigorous rules safeguarding financial stability, but of

recalibrating them through fine-tuning to make them compatible with the need to finance investments in infrastructures, innovation, R&D and technology, necessary for reviving growth and competitiveness, which are, in turn, conditions that enable the sustainability in the long-term of the fiscal consolidation processes.

There is still time in the delegated decrees on Solvency II, even if it is limited, to obtain more favourable treatment for long-term investments. It is hoped that pension funds could capitalise on the work done by insurance companies to obtain several significant changes. With regards to IAS, in relation to the business model and mark to market philosophy, the subject was brought to the attention of the FSB after the St. Petersburg G20 summit, but the road still seems to be rather an uphill one.

- b) A lot can be done in relation to the subject of fiscal incentives. Obviously great attention should be paid to the risks of moral hazard. This means avoiding fiscal incentives contributing to distort risk assessment. The introduction of fiscal incentives is justified specifically in those cases in which they can be used to correct external effects which come from market failures, as in the case of project finance. Taxation on businesses, in the majority of countries, tends to favour debt over risk capital, thereby creating incentives to use leverage ratios that are usually too high. Interests on debt are, in fact, deductible, while capital returns are very often not. The reduction of financial leverage should be an important goal of the economic policy of governments. Fiscal incentives could also encourage the PPP. On the one hand, they allow investments to be made which would otherwise not be made because they need public resources; on the other hand, these investments make a positive contribution to growth and therefore to fiscal consolidation. This is an undeniable fact, at least in all those cases where the incentive is closely directed at rebalancing the financial plan of something that has been negatively impacted by the cancellation of subsidies or by an increase in bank loan costs. It should be limited to a portion of greater taxes yielded, generated by the investment, after replacement factors.
- c) The third part of our new framework in favour of investments in project finance and in PPP is the mitigation of non-financial risks and regulatory costs. Political and legislative stability, lean and rapid administrative procedures, limited regulatory and bureaucratic burdens, a rapid and reliable judiciary system, an efficient and technically prepared public administration, are, as everybody knows, decisive factors in investment decisions, which currently have the entire globe as their horizon. Under the scope of European administration, which has finally found a legal basis in the Treaty of Lisbon, one can now think about a European policy of better regulation aimed at ensuring the convergence of European and national regulations towards investment-friendly models.

6. In this transition phase, infrastructures actually express some typical idiosyncratic characteristics of the newly established markets. As I have just pointed out, the supply of finance has become plentiful again, but the eligible project pipeline is still scarce, even in more advanced markets such as Europe. Investment grade project pipelines are missing, therefore projects that are not only bankable, but also not suitable for more prudent categories of investors in capital markets, such as pension funds and life insurance companies. The complexity of the construction and funding of a large work, especially

in sectors with a high technological content or high regulatory or macroeconomic risk, requires complex collaboration between various parties, and not just for a short period of time, but, in many cases, for 30 or 50 years. The public sector, for example, in many EU countries, does not always appear to be up to the challenge, both technically and from a political, regulatory and administrative point of view. The EU can and should do a great deal in this regard; the measures and policies outlined above may in fact help to maximize the return expected by from many projects now considered non-investable; but the individual member countries should also work on the regulatory context and technical quality of the public structures involved, with various roles, in PPP initiatives.

With less burdensome regulations and with appropriate incentives, new infrastructure can be financed by existing infrastructure. Such infrastructure actually generates important income, which can and should fund development. Naturally, in order for existing infrastructure to be able to fund new works, they must be of a consistent size and not fragmented. Overcoming the fragmentation of the infrastructure sector, creating new private but institutional investment instruments, to unite existing infrastructure in production chains, in order to ensure operational efficiency, balanced financial management, avoiding the impoverishment of society with excessive indebtedness and special dividends; reinvesting most of the generated cash flow in the development of assets and managed networks. These are some of the principles that should guide the process of re-launching investments in infrastructure.

In a time in which public finance is an extremely scarce resource, the infrastructure gap – quantitative and technological – can be bridged with the modern model of institutional finance: use resources derived from the efficient management of existing infrastructure to finance the development of new works; attract capital and private funding to ensure adequate returns and reduced or adequately mitigated risks.

7. But who are the potential backers of works in PFI and PPP? And which are the most suitable financial products?

In the financing of medium and large Greenfield projects, the instruments that can be used by long-term institutional funds (pension funds, insurance companies) are limited, for the time being, to the following: (i) unlisted equity, possibly alongside highly reputable private equity funds, which also play a role as investors; (ii) project bonds underwritten by the EIB (in this case the guarantee and the illiquidity premium justify a higher return); and (iii) through the direct equity interest in the debt by shadow banking.

This type of investment is limited to pension funds or large insurance companies who are the only ones capable of creating these instruments in-house or of acquiring “independent evaluation capacity” from the market.

The numerous smaller pension funds and insurance companies, on the other hand, have difficulty with the internal assessment capacity of the infrastructure risk.

In general, therefore, the new non-banking funding model of infrastructure could require the creation of a new category of intermediaries, capable of acting as a bridge between investors and investments, and also greater standardisation of financial projects and products for infrastructures.

The same type of scheme is also valid for medium and large Brownfield works. The expertise required in this area is, however, different and returns are, on average, lower because they tend to be less risky. Currently, demand for Brownfield works by investors is far greater than for Greenfield works. However, in general, in the coming decades, in emerging economies, but not only, the need to construct new works will be far greater than the requirement to manage and modernise existing works.

8. The global equity market for infrastructure is worth just under 500 billion dollars (Dialogic 2013 figures) of which two-thirds is in Europe. The debt is approximately 2,000 billion dollars. Merely by way of an example, this amount can be compared with the approximately 90,000 billion of assets managed globally by pension funds, insurance companies and sovereign funds.

The growth potential of these instruments globally is therefore exceptional. Demand for infrastructures in the coming decades, in Europe and globally, will be equally exceptional. Therefore, competition in attracting funding for infrastructures will be played out in countries and regional areas that know how to offer the best regulatory frameworks for investments.

Mind you, pension funds and other long-term institutional investors are not being asked to become the major backers of infrastructures. It is a question of promoting the establishment of a new model in which this type of investors is placed in a position of increasing its investment capacity in the infrastructural asset class by at least two or three times. Providing incentives for a greater allocation on behalf of institutional investors in infrastructure investments, going, for example from the current figure of 3% aiming to double it over the next five years would make a significant additional contribution to the funding of infrastructures. Debt for infrastructures has a lower default rate than that for corporate debt, in other words a default rate of 0.5%. In addition, debt for infrastructures has a better recovery rate than that for corporate debt (Standard & Poor's, 2013). It could therefore become an excellent new asset class to be "inserted" in pension fund and insurance company financial statements among government bonds and industrial and bank bonds.

As everybody knows, Canadian and Australian funds are already currently investing approximately 15% in infrastructures. I do not believe it is possible to reach this level in other countries in a short space of time, but getting close to this level should be the aim of a "new" European financial policy for infrastructures.

9. In contrast – but of no less importance – is the case of smaller works in PPP, such as, for example, social infrastructures (hospitals, schools, nurseries, social housing, prisons, public buildings, works for regional and environmental protection) or energy infrastructures or infrastructures of other sorts, but which are always medium or small in size.

If we want these types of works to also be funded, at least in part, by long-term institutional investors, they need to be standardised and gathered together – to create a greater critical mass – in dedicated portfolios. On the other hand, works funded through retention fees (based on the English example) give investors more certainty with instruments related to long-term concessions where the regulatory, political and market risk is

decidedly higher. This poses certain challenges which should be at the centre of the EU policy actions in the next legislative period.

10. New instruments and new public/private agencies are also needed to mitigate the risk and hedge market failures. The role of the major national and multilateral promotional banks (EIB, KfW, CDC, CDP, etc.) has grown with the crisis and will remain crucial for years. In recent years they have played an important countercyclical role. They have created new financial instruments and new guarantee schemes; they have provided significant additional resources to support the economy during the crisis.

They may have a role as catalysts in the participation of institutional investors in funding infrastructures and activate credit enhancement instruments, leaving institutional investors to play the senior role in the debt or attracting co-investment in project equity. The project bond Initiative could generate important multipliers. The Greenfield Marguerite Fund could be used as a prototype for a larger family of Funds for investments in infrastructures, technology, R&D, SMEs, start-ups, energy, urban development, healthcare, etc. Among the new instruments that these government agencies can strengthen (including under the scope of the Juncker Plan) are credit enhancement mechanisms, such as credit enhancement for risk mitigation, which can include credit and risk guarantees, first-loss prevention, and the provision of a bridging loan through direct loans.

The global financial markets are going through some radical changes. During this process, the banks are forced by the crisis and new international regulations to reduce long-term financing of infrastructure and the actual economy. Promotional banks are in a position to partly remedy this failure; using their capacity even more to absorb the risk and acting as brokers in the development/transformation of loans.

Promotional banks have an important opportunity ahead of them and the chance to reinvent themselves. They have the credibility to act as financial intermediaries thanks to a long history (and track record of success); predictable (and non-volatile) behaviour; they are untouched by the malpractices that led to the crisis; they are known for the attention and quality of structuring financial transactions; they enjoy preferential creditworthiness; they have political weight policy rather than profit-oriented institutions, in spite of this we have always had returns consistent with the risks (and the market).

Conclusions

Many years have passed since the subject of long-term investments was discussed with regards to the crisis and the failures of the development model that led to the crisis. A great deal of progress has been made since then, at least in identifying political and regulatory solutions. Not only in Europe, but also in the rest of the world. The need to promote long-term investments in infrastructure, innovation and education in order to build sustainable growth is shared by governments, large international organizations, the G20, the market and the European Union. In Europe, specifically, the Commission has produced an action plan which contains the road map for the next European legislature with several important indications. For some of these there is a wide consensus, for

others less so. Some are technically easier, others more difficult. But international and European regulators still appear to be dominated by a purely financial approach, which, by ignoring the fact that financial stability is inevitably precarious in times of stagnation, it ends up perpetuating pro-cyclical behaviour and encouraging the speculative reasoning that led to the crisis. And policy makers are struggling to move from words to facts.

The Italian presidency of Europe in this six-month period has played a significant role in conveying the process from one European legislative period to the other. After six years of talking it forcefully and bravely demonstrated that the time has come to move on to action.

Europe has a lot to do at present to gain back the ground it has lost: it has to fill the gap of infrastructures, which are the connective tissue of every modern economy. In order to work properly, infrastructures must be created and managed like networks. They must develop and be coordinated with one another in a rational way: they must be managed from a European perspective rather than a “country system” perspective or through financial speculation. In the case of infrastructure, priority must therefore be given to networks: to European energy, transport and communication networks.

Investment in Europe needs a new architecture: the Eurosystem of National Promotional Banks

Natacha Valla

Six years after the severe recession of 2009, private sector investment in Europe is still dangerously sluggish. And public sector investment has been cut, reinforcing the downward trend seen over the past thirty years.

In this talk, I want to discuss the complementarity between private and public sector investment. Evidence we and others have shed light to suggest that in the medium term, public investment does not hinder, but fosters, the quantity and efficiency of private investment. Moreover, our fiscal multiplier for public investment (at 1.4, considerably above 'breakeven') is significantly stronger than those for other fiscal instruments. Taken together, these two findings suggest that the public sphere would be well advised to tilt spending towards investment in areas such as infrastructure and human capital, which represent an investment for future generations.

In the Autumn 2014, the newly arrived European Commission, under the leadership of Mr Juncker, launched a large scale initiative, the Juncker Plan. But beyond that, or embedded in it, a new architecture should be designed to make sure that excess savings do not get stuck in the balance sheets of financial intermediaries, but are instead channelled towards productive outlets. To this end my coauthors Thomas Brand and Nicolas Doisy and I propose to start with the para-public sphere by establishing a Eurosystem of Investment Banks (ESIB), around a pan-European financial capacity that would coordinate the actions of the national public investment banks of Euro area member states and add to their funding capacity.

The ESIB would channel the Euro area's excess savings towards investment in the right places throughout the continent. To do so in an economically sustainable and financially profitable way, funding would be conditional on firm commitments to growth-enhancing structural reforms and economic policies.

Our proposed Eurosystem of Investment Banks (ESIB) would be structured around a European central entity – that very much looks like Juncker's European Fund for Strategic Investment (EFSI) – and national entities. But unlike the existing sketch for the EFSI, the central node would be created by restructuring the European Investment Bank into a truly European central entity. The European Fund would orchestrate the joint work of national investment and development banks with a clear European map in mind.

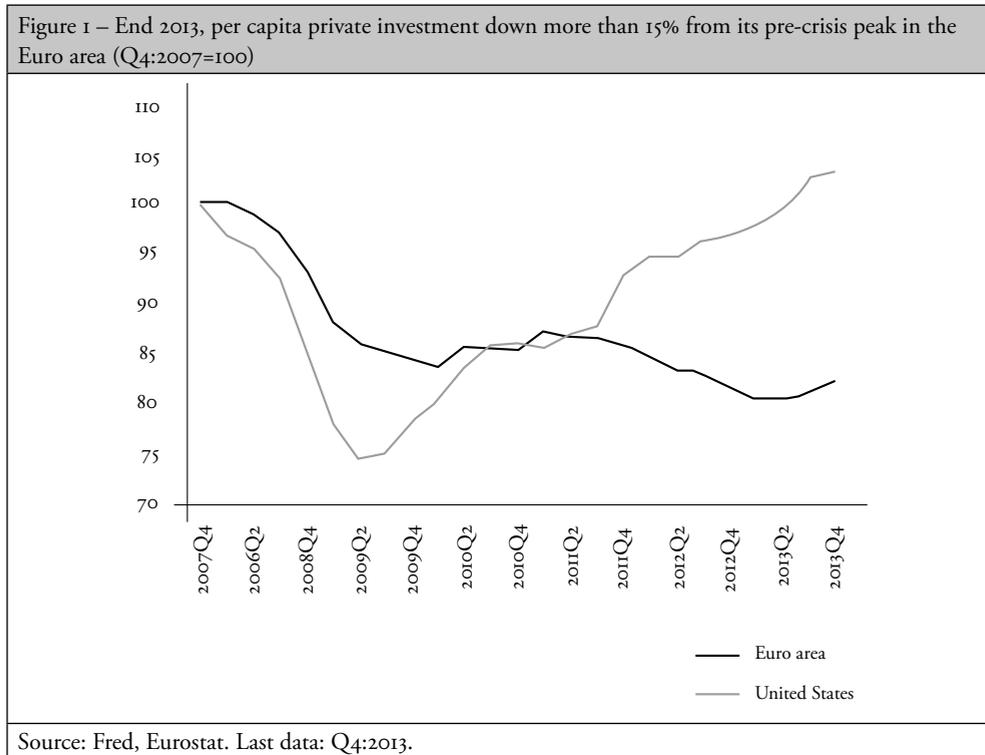
The mandate of the ESIB, enshrined in the Treaty, would be to promote long-term growth, well-being and employment in Europe. The mandate would, by definition, reflect a political consensus emanating democratically from the people of the Euro area member states.

The ownership and governance of the European Fund would be key in ring-fencing the investment process from national political agendas not linked to the promotion of long-term growth. We propose a structure with both public and private shareholders, who would collectively elect the ESIB Board of Directors. The European Fund would also issue debt to finance investment at an economically relevant scale (10% of Euro area GDP, so around €1tn).

1. Investment, public and private, is dismal in Europe

1.1 Private sector investment is extremely sluggish

Following the global financial crisis, there was a sharp decline worldwide in the rate of investment. In the US, real private investment per capita declined by 25% from its peak in Q4:2007 to its trough in Q2:2009 (see Figure 1).

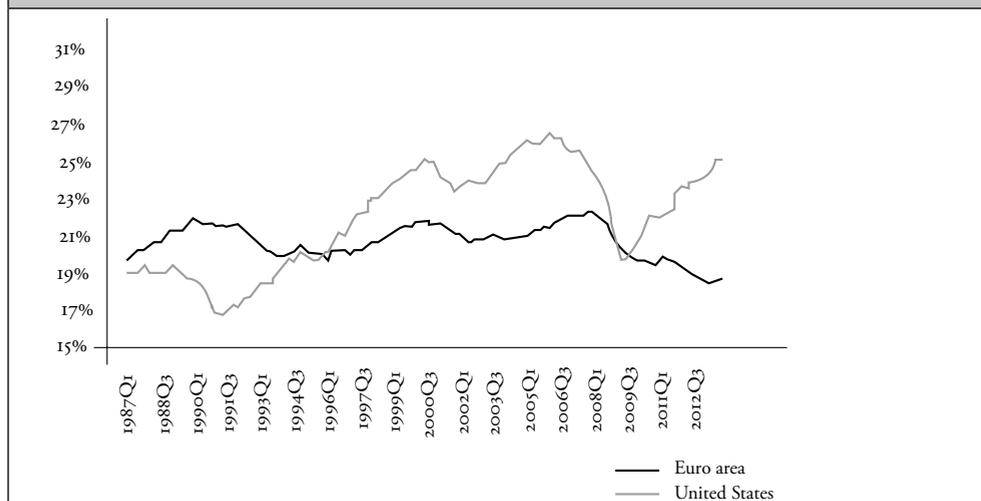


Although the fall was less spectacular in the Euro area, it also saw a sharp decline over the same period, down 15%. But more worryingly, in Europe, private sector investment continued to tumble for a long time after the trough of the crisis, whereas in the US it recouped and has now overtaken its pre-crisis level. The poor dynamics of European investment in recent years are even more striking when expressed in terms of GDP (see Figure 2). In stark contrast with

the US, private investment in Europe fell to below 19% of GDP as at the end of 2012, while in the US it had recovered to around 25% of GDP – 6 percentage points of GDP are a substantial difference and represent hundreds of USD billion per year.

Rebooting private sector investment and channelling investable funds to the right places on the continent is therefore a major challenge for policy makers in the wake of the severe recession of 2009.

Figure 2 – Private sector investment now less than 20% of Euro area GDP (% GDP)



Source: Eurostat, Giannone et al. (2012). Last data: Q4:2013.

1.2 Public sector investment has resumed its secular downward trend

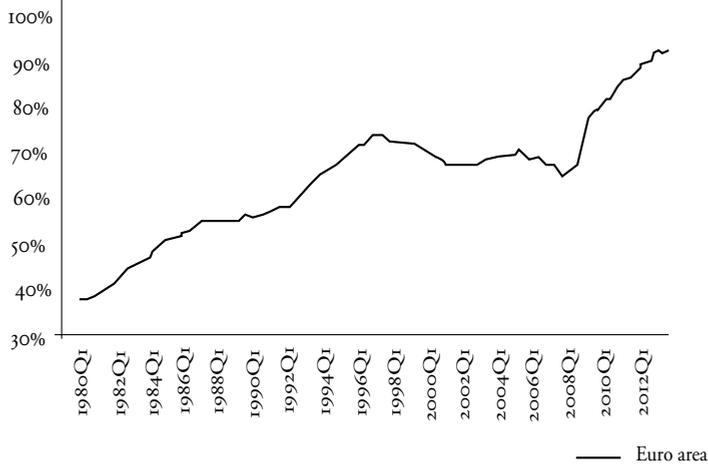
The prolonged cyclical weakness of private sector investment is compounded by adverse secular developments in public sector investment. With the crisis, public finances have been put under strain, as states have had to both offset the contractionary impact of the financial crisis, and spend money on their banking systems to avoid systemic contagion. A steep rise in the stock of public debt has ensued (see Figure 3). To contain the dynamic accumulation of public debt, governments have embarked on substantial consolidation efforts, leading to further declines in public investment.

But the reduction in public sector investment is not new. In fact, it dates back to the 1980s (see Figure 4), a time when governments used to spend around 4% of their domestic product to finance investment using public funds. Taking a step back, it appears that the ratio of public investment over GDP has declined in three successive stages over the past 35 years – in the early 1980s, in the mid 1990s, and since the 2008 crisis, coinciding with episodes of strong fiscal consolidation. And over these 35 years, the downward trend has never reversed.

This downward adjustment in public investment gave rise to much debate in the 1990s with a plethora of literature on the subject. By then, the marked decline in the ratio of public investment over GDP had (already) become a stylized fact for many

industrialised economies, and economists started to look for systematic evidence on the relationship between public sector investment and economic growth (Aschauer (1989a,b), Gramlich (1994), Otto and Voss (1998)). But for some reason, the interest of macroeconomists was diverted and it is only now, with the threat of “Secular Stagnation” (Summers (2013)), that public investment has returned to the front of the stage.

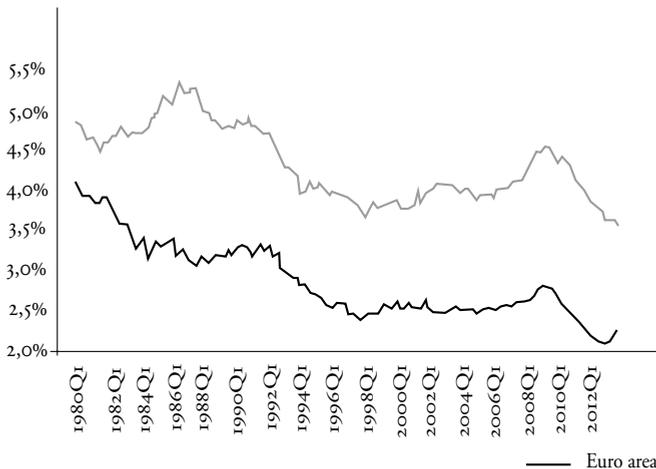
Figure 3 – High public debt surely a constraint on public sector capex (% GDP)



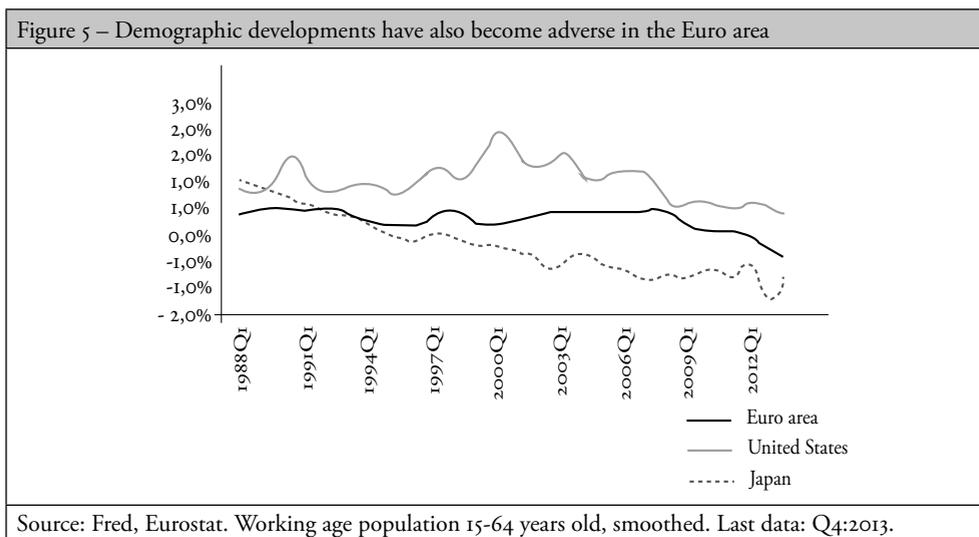
Source: Fred, Eurostat. Last data: Q4:2013.

And this threat might become even more acute given the adverse demographic developments already taking place in the Euro area (see Figure 5).

Figure 4 – Euro area public sector investment halved to 2% of GDP in 35 years (% GDP)



Source: Fred, Eurostat, Paredes et al. (2009), Giannone et al. (2012). Last data: Q4:2013.



1.3 Risks to the capital stock and potential growth in Europe

The decline in investment raises concerns that capital stocks, both public and private, could depreciate without proper replacement, fall to sub-optimal levels and possibly impair the potential rate of economic growth. There are well-known reasons behind these concerns. First, the outstanding stock of private productive capital decays over time. If it is not properly replaced, production capacities shrink, inducing a suboptimal combination of production inputs (ie, capital versus labour versus technology). Second, with technological progress, capital stock becomes obsolete. If it is not updated, as the new technology becomes entrenched, relative productivity falls.

1.4 Complementarity of private and public investments boosts case for public investment

But the consequences of underinvestment go beyond the implications spelled out above. In particular, the interaction between the public and private provision of investment matters too. First, public and private sector investments might be more complements than substitutes – that is, an increase in public sector investment could boost, and not crowd out, private sector investment. Such might be the case if, for example, public investment in infrastructure or networks (energy, digital) improves the efficiency and allocation of private investment for specific firms, sectors, or projects. Second, the public sector might also invest in profitable areas where the private sector fails to channel funds because of market failures. Third, public investment could serve as a financial trigger for private sector financiers to engage in projects they would not have engaged in on their own, for example because of the projects' large size. Over its history, the European Investment Bank (EIB) has provided many concrete examples of such interactions.

The complementarity between public and private investment seems crucial to us, for if they are complementary and not substitutes, the case for boosting public sector investment would be even more compelling. So we found it worthwhile to check the idea.

The framework we use to assess this complementarity between public and private sector investment is a neo-Keynesian model with nominal and real rigidities that have been identified as empirically important, such as sticky prices and wages, habit persistence in consumption and adjustment costs in investment. A fraction of households is assumed to be excluded from financial markets (they can't borrow or save). This model is based on the New Area Wide Model developed by the ECB (2008),¹ to which we add public capital as an input for the production of domestic intermediate goods.²

We find that, on the basis of Euro area data:

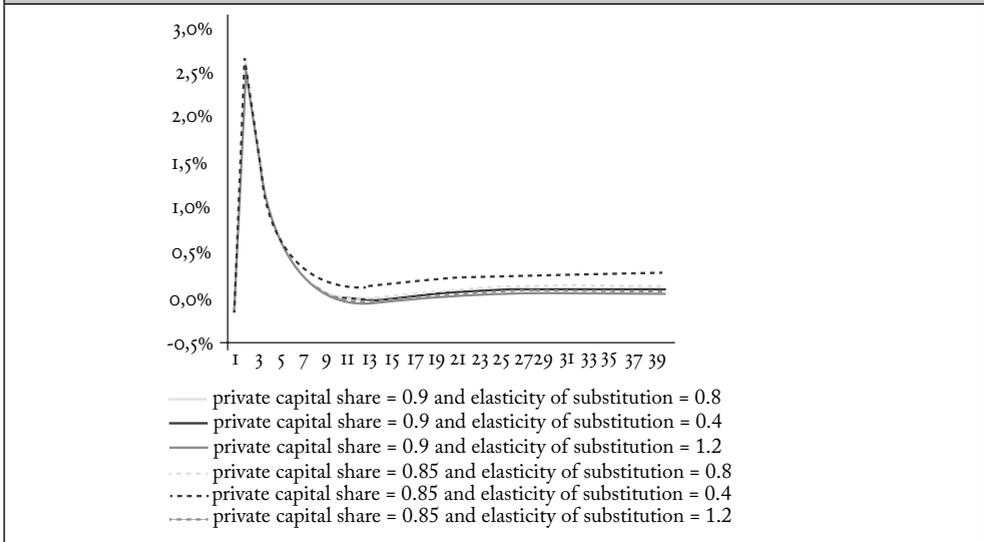
- The quantitative effect of public investment expenditure on output is of first order magnitude. The fiscal multiplier for public investment, ie the induced impact of an increase in government investment spending on real GDP growth – is 1.42 (see Table 1). That is, an increase in public investment worth 1% of GDP boosts GDP growth by 1.42% initially. The fiscal multiplier gains momentum over the subsequent two years, and remains at 1.46 five years on. This is significantly more than the multipliers applicable to other fiscal instruments, as shown in Table 1: 1.38 for government consumption, 0.92 for social transfers, 0.55 for VAT cuts, and only 0.37 for employees' social contributions. Our findings suggest that governments might be well advised to be aware of the short- and longer-term implications of cutting investment, were they tempted to cut investment expenditure instead of adjusting other budget items for short-term consolidation purposes.
- Conducting a sensitivity analysis on the elasticity of substitution between public and private capital, we find that in the medium term even at the low end of the elasticity range, ie, with a low complementarity between both types of capital, public capital has a crowding-in, and not a crowding-out effect on private investment. With an elasticity of substitution of 0.8 (a parameter of 0 corresponds to the case where public and private capital stocks are perfect complements, and a parameter going to infinity corresponds to the case where they are perfect substitutes)³, the response of private investment to an increase in public investment is positive at the end of the 3rd year.
- Increased public investment always leads to a persistent increase in the output and total capital stock of the economy. This increase is more pronounced when the share of public capital in the overall capital stock of the economy is high to start with (ie, the dotted lines, as opposed to the plain lines in Figures 6 to 8).

1 The NAWM is an open economy DSGE developed at the ECB. It is specified in an open economy setting, incorporating frictions such as local-currency pricing (giving rise to imperfect exchange rate pass-through in the short-run), and cost of adjusting trade flows.

2 More precisely, physical capital in the economy is a Constant Elasticity of Substitution (CES) aggregate of public and private capital stocks. This physical capital is then combined with labour input and technology in a Cobb-Douglas production function.

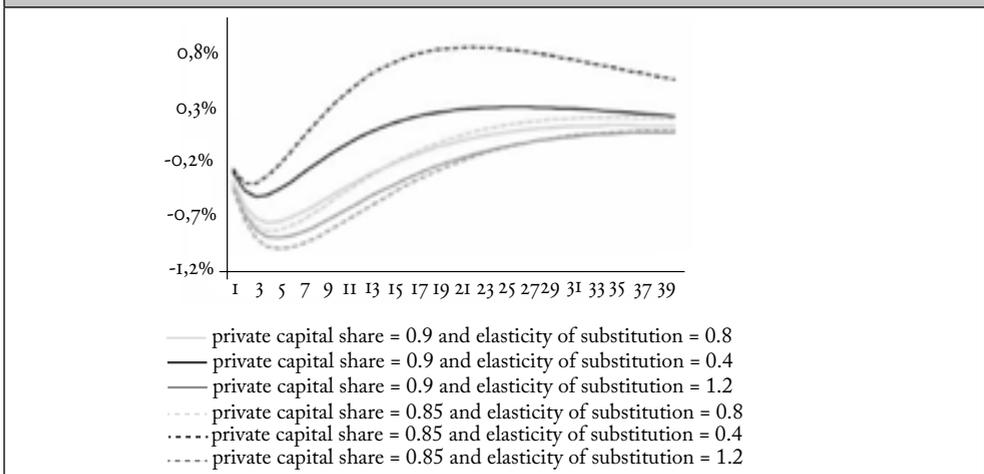
3 This figure is the same as Coenen, G., Straub, R. and Trabandt, M. (2012) but we have to note a particularly wide confidence interval of [0.2;1.6].

Figure 6 – Positive effect of increased public investment on output is persistent



Source: Authors' calculations. The x-axis displays quarters after a one standard deviation shock to public investment.

Figure 7 – Complementarity between private and public investment limits crowding-out in the short term



Source: Authors' calculations. The x-axis displays quarters after a one standard deviation shock to public investment.

Empirical studies show varying levels of fiscal multipliers for public investment. There is also growing evidence that the multiplier varies along the economic cycle, and becomes higher in recessions. Christiano et al. (2011) show that the fiscal multiplier can even be above 2 in such circumstances. Combined with the longer-term arguments developed above, this reinforces the policy case to boost public investment. That case goes well beyond a short-term, purely Keynesian, growth impact. It also pertains to the long-term growth performance of the economy.

Table 1 – Fiscal multipliers by specific instrument for the Euro area				
	Immediate	One year later	Two year later	Five year later
Government investment	142	153	157	146
Government consumption	138	14	141	138
Targeted social transfers	0.92	1	1.03	0.89
Taxes on consumption	0.55	0.8	0.87	0.71
Social contributions of employees	0.37	0.45	0.46	0.25

Source: Authors' calculations.

Note: The numbers shown in the table represent cumulative, net present value multipliers, ie, the sum of output variations up to the indicated year, divided by the sum of fiscal variations up to the indicated year, both discounted at the risk-free short-term interest rate in the neo-Keynesian model described in the text.

2. Private investment faces financial head- and tailwinds in the Euro area

2.1 Private investment is facing headwinds...

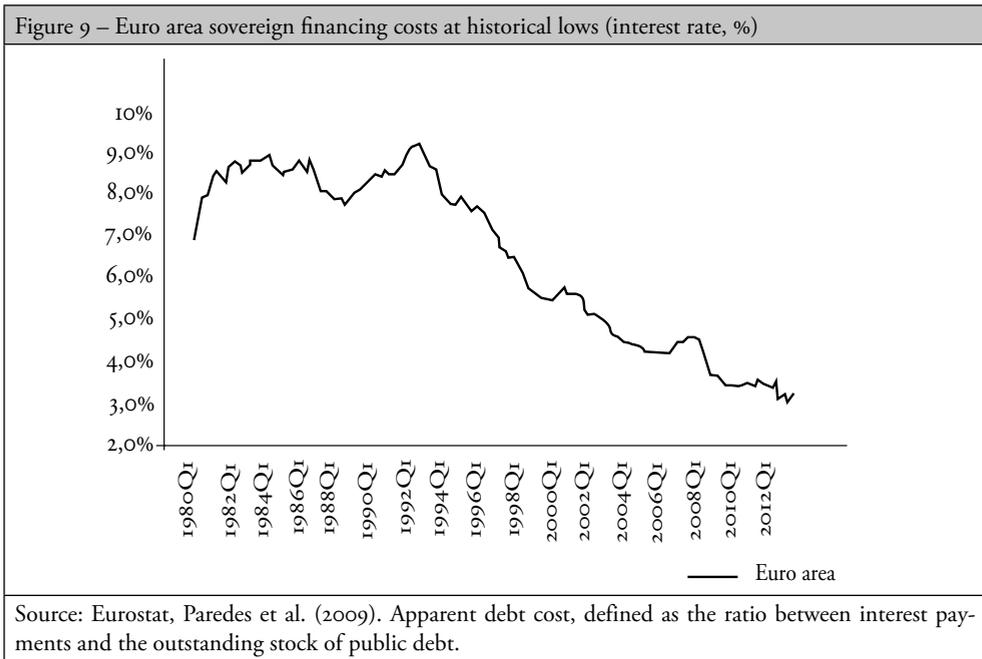
Investment financing is currently facing two headwinds. First, financial fragmentation, which still prevails in both the wholesale and retail markets. Second, the drastic reduction in bank lending, which is leaving a black hole in the way Europe finances growth. If these persist for too long, financial fragmentation and deleveraging-induced bank retrenchment will inhibit any pick-up in investment, and eventually lower potential economic growth.

2.2 ...but there are enough savings in the area...

Although vulnerable, investment in the Euro area is not a lost cause. In fact, the financial fundamentals are sound: the region has savings in excess (and a significant current account surplus), its aggregate fiscal capacity is sound, and many potential investors would put money on the table if they were given the tools and rules to operate optimally at a pan-European scale.

2.3 ...and the cost of financing is historically low

There are also opportunistic arguments in favour of raising public investment in the current environment. A very compelling one is the cost of funding, which is extremely low. The apparent interest rate on sovereign debt, computed for the Euro area, is hovering at around 3-4% (see Figure 9). For comparison, sovereigns had an apparent annual interest rate of 7-9% all through the 1980s. Five percentage points do make a difference. To finance 1% of Euro area GDP is around €50bn cheaper in 2014, in terms of saved annual interest repayment costs, than if we were facing the same financial conditions as back then.



3. Reshaping the landscape of public investors in the Euro area

From a political perspective, the economic and financial circumstances described above could be seen as a good opportunity for policymakers to take action to kick-start investment. A natural starting point to see how this could work is to look at the institutions currently in charge of channelling public funds towards investment, and see how they interact.

3.1 The national investment banks – history, investment coverage, governance and funding

There are many national development banks in Europe. Some are sizeable. All are well established and widely respected institutions. Some might own magnificent collections of art pieces, be located in prestigious historical buildings in their country's capitals, and have financial stakes in the “jewels” of national industries. Their senior staff might belong to the national elite, and their scope of activity be often associated with the economic and strategic interest of the nation they serve.

In the three largest economies in the Euro area, France, Germany and Italy, the institutions in charge of public investment share a common history in that they were all set up to fund expenditures related to a war (or to its aftermath). But each has developed along different lines in terms of style, structure, and resources.

In Germany, the Kreditanstalt für Wiederaufbau (KfW) was formed as part of the Marshall Plan in 1947, with the original mission of rebuilding Germany – but its role gradually evolved to a much broader agenda of capital market activities (mostly, but not exclusively, debt issuance), bank refinancing, project co-financing, the promotion of German Small and Medium Enterprises (SMEs), housing, export and municipal in-

frastructures. It is mostly domestically oriented, but also engages at the margin in the emerging world and in southern Europe. In terms of governance, the KfW Group is 100% publicly owned by the German European State (80%) and German Länder (20%). The bulk of its financing activities is funded through debt issuance, for which it benefits from explicit government guarantees.

The French model shares a few similarities. In France, the Caisse des Dépôts et Consignations (CDC) was created in 1816 at a time of high public debt, when as a consequence of the Napoleonic wars the French state was forced to borrow at a high interest rate. The legend goes that Louis XVIII set up the CDC in misfaith of the Banque de France, itself freshly created at the time, because he needed a bank to buy public debt instruments. But it is more likely that there was a need for an independent institution to protect public savings. The 1816 CDC founding law – still quoted on the CDC website today – provided CDC with a statute and governance that was meant to shield it from political cycles (thanks to a “Parliament’s supervision and guarantee”). The Law was updated in the mid 2000s, but the spirit remained the same. Over time, CDC (and its banking arm for SMEs created in 2012, the Banque Publique d’Investissement (BPI France)), has become a major long-term investor. It is involved in housing finance (a long tradition), infrastructure, regional finance, equity and loans financing. CDC’s main sources of funding are postal and regulated retail savings products.

Italy’s Cassa Depositi e Prestiti (CDP) was set up in 1850 by the Kingdom of Sardinia, before the unification of the country (again, the legend goes: as a follow-up to the costly 1849 war against Austria). Throughout its history, CDP has been through various forms of corporate structure and governance – having been successively a bank, a Directorate General at the Treasury, and, since 2003, a joint stock company (its current status). In terms of ownership, about 80% of the capital is owned by the Ministry of Economy and Finance, 18.5% by banks, and 1.5% is in preferred shares. CDP’s activities cover the financing of public investment and other public entities, infrastructure investment and the financing of public companies, as well as works, plants, networks and equipment intended for the supply of public services. It also controls the Fondo Strategico Italiano (FSI), which acquires stakes in firms of “significant national interest”. Its main sources of funding are postal savings. CDP also issues bonds that are not guaranteed by the state.

Spain’s Instituto de Crédito Oficial (ICO) is of more recent origin. Its Articles of Incorporation were approved in 1999. It is a state-owned credit institution attached to the Ministry of Economic Affairs, with an independent management team. It finances itself on the national and international capital markets by issuing bonds that are guaranteed by the Spanish State (explicitly, irrevocably, and unconditionally). ICO Group also includes a venture capital entity.

3.2 A heterogeneous bunch

The brief descriptive summaries above show how national investment banks can differ in their investment profiles, governance, and funding structures. Additional stylized facts are summarized in Table 2 below, suggesting that:

- Public investment banks are already large relative to their countries' GDP. This is particularly the case in Italy (the size of CDP measured in total assets, €305bn, was worth 19% of Italian GDP in 2012) and Germany (€497bn, 19% of German GDP).
- They are also significant lenders compared to the aggregate amount of loans issued by banks.
- They have grown at a steep pace since the start of the crisis in 2008, with their balance sheet size up by 30-90% between 2008 and 2012.

Table 2 – Public investors differ in size, scope to grow more for some							
EURbn	KfW	CDC	BPI France Financement	Cassa Depositi e Prestiti	ICO	European Investment Bank	Total
Balance sheet total (Total Assets, 2012)	497.5	393.7	29.9	305.4	115.2	508.1	1850.0
Total bans	118.5	155.6	15.6	100.5	88.8	293.4	772.3
Country	Germany	France		Italy	Spain	Europe Union 1/	
Long-term credit rating	AAA/aaa/AAA	AA/AA1/AA+		BBB/Baa2/BBB+	BBB/Baa2/BBB+	AAA/Aaa/AAA	
Memo							
Nominal GDP (2012)	€ 2666	€ 2032		€ 1576	€ 1029	€ 12960	
MFI Loans to NFC	€ 909	€ 876		€ 875	€ 729	€ 4674	
Balance sheet/GDP	19%	21%		19%	11%	4%	14%
Total bans/GDP	4%	8%		6%	9%	2%	6%
Total banks/MFI Loans to NFC	13%	20%		11%	12%	6%	17%
Source: Bloomberg, Annual Reports, Authors' calculations. ICO: Instituto de Crédito Oficial. MFI: Monetary and Financial Institutions. NFC: Non-Financial Corporation.							
1: Except MFI Loans to NFC, for which the aggregate field is the Euro area. Also Note that in the case of CDP, total loans include loans to banks.							

3.3 *The European Investment Bank (EIB)*

The idea of pooling resources to foster investment in Europe is not new. It has been built into the European institutional framework for a long time, starting with the creation of the EIB in 1957 with the Rome Treaty. The EIB is somewhat similar to the German

KfW in terms of its capital ownership and specialisation. The EIB belongs to the 28 Member States of the European Union, each of which holds EIB capital. The EIB is an important bond issuer and financial resources raised in the markets are used to finance projects mostly in Europe in the fields of SMEs, innovation and skills, strategic infrastructures, and climate change. Outstanding EIB loans increased steeply between 2008 and 2012, but its balance sheet remains smaller than that of the national banks, at least when measured in relation to Euro area GDP (it is worth 4% of EU domestic product – around €508bn).

There are fundamental differences between the EIB and its national peers:

- The EIB is by conception an investment bank. Most of the national development banks were conceived as the funding arms of governments. They might have become closer in spirit to an investment banking model, sometimes through the creation of specific financing entities, but their original purpose remains prominent.
- The EIB was born with Europe in mind. It is “the European Union’s bank” established by Treaty.⁴ Its main tasks are to “promote EU goals” by providing funds, guarantees and advice to finance long-term projects. By contrast, national investment banks have been shaped in reference to national territories. And even though the EIB is owned by EU Member States and represents their interests, its ultimate objective is linked to furthering EU policy goals. So the EIB is expected to be immune from national political cycles.

3.4 Joint initiatives are many, but still sporadic

The formidable rise in recent years of the EIB mirrors that of the national entities. And in parallel, a number of key initiatives have been launched to “think jointly” about long-term investment in Europe. Bassanini and Reviglio (2014) provide a very nice narrative of the progressive steps that led to the creation of key initiatives. The Long-Term Investors Club (LTIC) was created back in 2009. In 2010, the experimental “Project Bond Initiative” was set up. And more recently, initiatives by think-tanks, such as Eurofi and Confrontations Europe, around public, long-term investment, have been geared up. Political initiatives have also flourished over the past couple of years. The European Commission itself has been quite proactive, with the commission of key reports – a Green Paper on the long-term financing of the European economy (2013), and a “Finance for Growth” report (2014).⁵ The 2020 European Fund for Energy, Climate Change and Infrastructure (“Marguerite”) was also established to make capital-intensive infrastructure investments. And in 2013, the Commission proposed launching a long-term investment fund (ELTIF). But these initiatives fall short of creating a coherent and coordinated system of investment across the region.

- 4 The Statute of the EIB was first established by the Treaty on European Union and the Treaty on the Functioning of the European Union (Articles 308 and 309 and Protocols N. 6, 7 and 28 annexed to these Treaties). Under Article 16.5: “The amount of loans and guarantees granted by the Bank shall not exceed 250% of its subscribed capital”.
- 5 A High Level Expert Group (HLEG) was set up in May 2013 by the Economic and Financial Committee (EFC). It published a report in December that year.

4. *A new architecture: the Eurosystem of Investment Banks (ESIB) and the European Fund*

The development of public investment banks and the intensification of joint initiatives over the past few years suggest that the ground might now be ready for a more profound institutional change to the public investment banking constellation. The many long-standing public investors in the Euro area could become collectively more effective by working as a “system” together, to improve failing levels of investment. But conceiving a “system” that preserves the strengths of each national model, while delivering efficient outcomes at the continental level, is challenging.

Despite these challenges, we thought it worth the attempt and propose the creation by treaty of a Eurosystem of Investment Banks (we suggest ESIB as an acronym, by analogy to the ESCB, the system created by national central banks and the ECB within EMU). The ESIB would enshrine co-operation between those institutions in European Law. It would also statutorily bring public development banks and private sector investors together.

The ESIB would consist of a central entity and the national investment banks (NIBs) of the EU countries that have joined EMU. For the system to work, the first steps to take are to:

- Define the central entity. Subject to statutory and treaty changes (and these changes might need to be substantial – see the treaty articles setting up the EIB in Box 1), a rechristened European Investment Bank (EIB) could take that role. But the EIB would need to acquire a truly European structure, and act as an investment fund.
- Define the “common denominators” that each member state’s NIB would need to meet. As a starting point, an NIB must actually exist, which is not currently the case everywhere in EMU.

4.1 *The political and institutional merits of a Eurosystem of Investment Banks (ESIB)*

An ESIB around a European Fund would mark a clear political commitment to European integration. And now, in the post-crisis era, could be a good political opportunity to push for this. It would pool financial resources across Euro area member states without involving national budgetary processes. Instead of looking at countercyclical spending, it would finance structural, long-term, growth-enhancing, and stability-promoting public and private investment. As such, it would resonate with recent recommendations made by the IMF and the 2014 Australian G20 presidency (warning against the generalised decline in investment ratios in the aftermath of the crisis – IMF (2014); and arguing for a revival of public-private investment to support global growth – G20 (2014)).

The ESIB would display a specific mix of characteristics: a truly European scope and risk diversification (assets and liabilities); the ability to encompass diversified investment cultures; balanced incentives between economic/financial returns and environmental/social standards; and independence from national politics. Within the ESIB, the European Fund could effectively facilitate the cross-border operation (and co-operation) of NIBs while preserving leeway in their statutes and prerogatives.

Looked at in the context of the post crisis environment, an ESIB would be able to foster progress in a whole range of areas, as suggested in Table 3.

5. *New mandate, new governance for public investment in Europe*

5.1 *Mandate*

Enshrined in the Treaty, the ESIB mandate could simply be to promote growth, well-being and employment in Europe. That mandate would be, by definition, a political choice emanating democratically from the people of the Euro area member states.

5.2 *Conditionality*

What would be the common purpose of the ESIB? As stated above, its primary aim would be to mobilise public and private funding towards financing jobs and growth in Europe. To do so in an economically sustainable and financially profitable way, it would need to grant access to its funding subject to certain conditions. Specifically, the financing of activities in the public sphere would, where necessary, be made conditional on firm commitments to implementing growth-enhancing structural reforms and economic policies. Any investments (co-)made by the ESIB would also generally integrate high environmental and social standards, as well as strong and politically independent governance.

5.3 *Investment criteria*

Choosing the investment criteria is a fundamental, strategic choice that needs to be robust through time. If the ESIB is to fulfil the mandate of promoting long-term growth, well-being and employment in Europe, then its investments would need to accord with one or several of the following criteria, but not in a mutually exclusive way:

- Be long-term
- Have a strategic dimension
- Foster European integration
- Serve as an anchor for non-investment grade countries
- Structurally help countries with impaired socio-economic environments

5.4 *Investment areas*

It goes beyond the scope of this paper to argue on the specific areas conducive to sustaining long-term potential growth, well-being and employment in Europe. But in light of current debates, it seems that the top four areas could be:

- Energy and climate change
- Human capital and innovation
- Infrastructure
- Digital

Obviously, strategic investment areas are very likely to change over the coming decades. We only have to look at the way in which public investment has diversified over the last thirty years, from being almost exclusively geared towards road and railway infrastructure, to see this. It is therefore important to draft ESIB statutes and its mandate so that it is not restricted

in the areas it covers and that it can redefine periodically its priorities, while keeping in line with its long-term objectives of potential growth, well-being and employment.

5.5 Financing and the role of the private sector

An appropriate structure is needed for the ESIB to fulfil its mandate while remaining economically and financially profitable.

As a core principle, all Euro area member states would be expected to become ESIB members, as would all EU institutions, with all the related rights and obligations this entails. They would irrevocably and unconditionally provide a predetermined contribution to the Fund's equity, possibly set in accordance to their GDP weight in the Euro area. The equity thus raised would be handled as an endowment by the Fund.

As a central entity to the ESIB, The European Fund would seek partnerships with the broadest possible range of investors, not just institutional investors and pension funds, but also loan funds, debt funds, venture capital, and private equity, and could even have explicit clauses to incentivise investor classes that tend to be under-represented (such as business angels or corporates).

The private sector could be involved in three ways: with an equity stake, as debt holder, or as co-investor. None should be a priori excluded:

- European equity shareholders. Private shareholders would be necessary to ring-fence investment decisions from political influences. Of course, sovereign members and public entities of the Euro area could be, but would not necessarily be, the majority shareholders in the Fund. But private shareholders would serve to counterbalance the political influence that comes with public sector ownership. To that end, we would not exclude the private shareholders' stake being close to or above 50%.
- European bond holders. As the central entity of the ESIB, the European Fund would be entitled to issue debt. As holder of that debt, the private sector – ie, potentially the global investment community – would thus be involved in financing ESIB investments. After all, the spending capacity of European states is likely to remain fairly constrained for the foreseeable future, so leveraging on private funding would be necessary to fund investment at an economically relevant scale.

As a large multilateral borrower, with substantial sovereign ownership and guarantees, the Fund would be likely to display high credit ratings allowing it to raise funds at advantageous rates, as is currently the case with EIB issues. The Fund should therefore be able to raise significant resources on international capital markets through bond issues.

Bearing in mind the size of the investment needs discussed in the first part of the paper, and taking as benchmarks the current balance sheet sizes of the NIBs, a reasonable target for the European Fund balance sheet would be 10% of the Euro area GDP (around €1tn as of 2013). This order of magnitude would be consistent with a return of public investment to 4% of Euro area GDP (from around 2% as it currently stands). The corresponding increase of public investment by 2% of GDP would finance 50% of the European Fund capital. The remaining 50% would come from private sector shareholders. The resulting European Fund capital would amount to 4% of Euro area GDP.

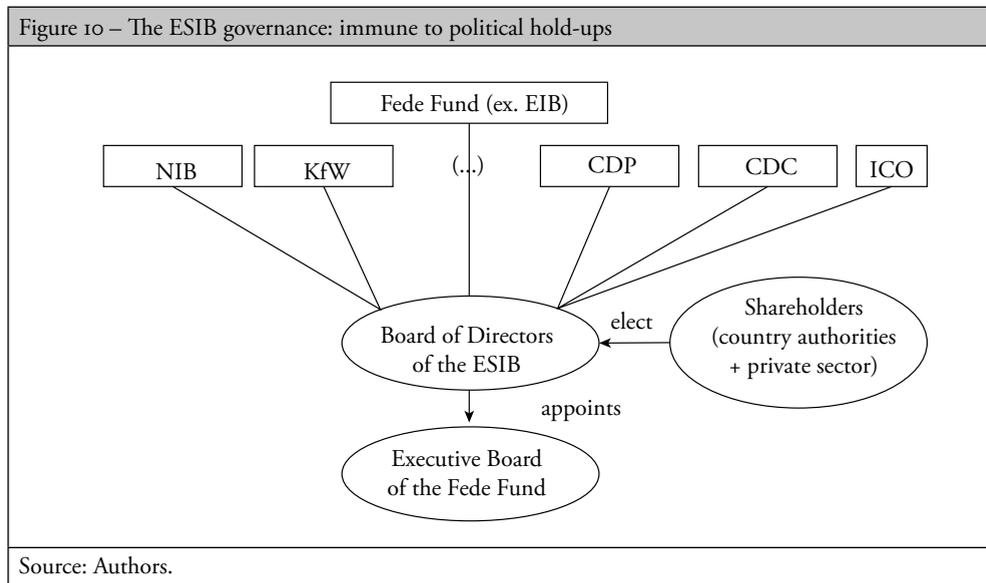
Assuming a leverage of 2.5 yields a balance sheet size of 10% of Euro area GDP. This leverage ratio is in fact in line with the Statute of the EIB (as quoted in Box 1).

- ESIB co-investors. We do not see any reason to spell-out ex ante limits on the modalities of co-investment schemes between the ESIB and private investors. The very diversified range of instruments and co-investments already implemented by the EIB and NIBs suggests that biodiversity should be sought not fought.

So to sum-up: European Fund public shareholders would come from the Euro area, investment areas would be spread over the EU 28 region, and the debt holders would be the global investment community.

5.6 Ownership and governance

On that basis, a possible architecture for the ESIB is depicted in Figure 10.



Given its mandate, the ESIB would be structured around a Board of Directors, elected by its shareholders, ie, sovereign members, public entities and private sector entities (see Figure 9). Voting rights would be set in line with the capital key of the European Fund's shareholders. Subject to these weights, a number of directors might, but need not be heads of National Investment Banks or Ministers of Finance. But other directors would also be elected purely by the private European Fund shareholders.

In turn, within the ESIB, the Board of Directors would appoint the Executive Board of the European Fund, to which most powers would be delegated. The Board of Directors would also lay down the principles for the investment and credit policy of the ESIB (discussed above as "investment areas"). It would delegate decisions related to the granting of funds and raising of loans to the European Fund's Executive Board.

Box 1 – Articles of the Treaty (TFEU) relevant to the EIB*Article 308*

(ex Article 266 TEC)

The European Investment Bank shall have legal personality.

The members of the European Investment Bank shall be the Member States.

The Statute of the European Investment Bank is laid down in a Protocol annexed to the Treaties. The Council acting unanimously in accordance with a special legislative procedure, at the request of the European Investment Bank and after consulting the European Parliament and the Commission, or on a proposal from the Commission and after consulting the European Parliament and the European Investment Bank, may amend the Statute of the Bank.

Article 309

(ex Article 267 TEC)

The task of the European Investment Bank shall be to contribute, by having recourse to the capital market and utilising its own resources, to the balanced and steady development of the internal market in the interest of the Union. For this purpose the Bank shall, operating on a non-profit-making basis, grant loans and give guarantees which facilitate the financing of the following projects in all sectors of the economy:

- (a) projects for developing less-developed regions;
- (b) projects for modernising or converting undertakings or for developing fresh activities called for by the establishment or functioning of the internal market, where these projects are of such a size or nature that they cannot be entirely financed by the various means available in the individual Member States;
- (c) projects of common interest to several Member States which are of such a size or nature that they cannot be entirely financed by the various means available in the individual Member States.

In carrying out its task, the Bank shall facilitate the financing of investment programmes in conjunction with assistance from the Structural Funds and other Union Financial Instruments.

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Views from the front-line: the shifting institutional framework

Institutional response to investing in Long-Term Europe

Gabriel Bernardino

When examining the possible institutional response to investing in long-term Europe, it is important to address two issues:

1. How can the role of insurers and pension funds as institutional investors be reinforced?
2. What should be the favourable conditions for long-term investments?

It is a common view that investments by the European financial sector should be well allocated according to the duration of liabilities that different market players have. Consequently, in order to have more long-term investments, we need to have more long-term liabilities.

The banking sector cannot be considered as a strong long-term investor because their liabilities are mostly short term. On the contrary, insurers and especially life insurance companies as well as pension funds can successfully play the role of institutional investors due to their long-term liabilities.

Focus on private pensions

To reinforce their role as institutional investors we need to increase the volume of their long-term liabilities. We can achieve this by *encouraging the development of private retirement savings schemes that could be funded through life insurers or pension funds*. Such schemes are essential for long-term investments and in my view they need to be part of the Capital Markets Union.

The demand for the retirement savings schemes can be raised if the relevant reforms of the European pensions are conducted. At the moment we witness the situation when over 40% of all the pension contributions are allocated to the social security system (the so-called 1st pillar pensions). With such a huge proportion there is no space for private retirement savings. It is necessary to gradually diverge contributions from the 1st pillar to the 2nd and 3rd ones (occupational and private pensions respectively). Such a move will definitely encourage the creation of long-term retirement savings schemes.

That is why the reforms in the area of private pensions should be the first priority in Europe.

In summer 2015, EIOPA launched a public consultation on the proposals for the creation of a standardised Pan-European Personal Pension product (PEPP). The overall objective of the proposal is to encourage EU citizens to save for an adequate retirement income and the creation of a simple, trustworthy, standardised and fully transparent product would be essential for this objective.

What would support long-term investments?

Besides the long-term liabilities, a number of other conditions are essential for long-term investments. For example a good part of life insurance maturities are still rather short, thus, we need to have more long-term products offered by insurance companies.

The liquidity of liabilities also matters. If policy holders can surrender at any time during the life of the product, it is impossible to do long-term investments. There is no free lunch! Therefore, long-term retirements saving policies should include elements mitigating the possibility to surrender. Furthermore, insurers and pension funds should build up the proper expertise and knowledge of long-term investments such as for example infrastructure projects. Currently not every company has the capacity to analyse the projects and to build good risk management. However, such expertise is crucial. Investing in sovereign bonds is not the same as investing in infrastructure projects where the company is bearing totally different types of risks such as legal, political or construction.

Finally, a fundamental factor is the certainty of the regulatory environment. Without it investors will be reluctant to participate in the projects. It is a political factor and such certainty can be provided only by the national governments.

Treatment of long-term investments under Solvency II

On 1 January 2016, the new regulatory framework for insurers – Solvency II – will enter into force. I think with Solvency II we are moving in a right way by focusing on the prudent person principle and the Own Risk and Solvency Assessment. Solvency II also includes diversification effects between the different risks. The more diversified portfolio companies have, the less penalising are the risk charges. That is why I do not agree with the statement that Solvency II is penalising long-term investments. It is just not the truth!

At the same time EIOPA remains open to further investigate the regulatory treatment of the infrastructure investments by insurers. In 2015, EIOPA published a discussion paper; consulted representatives of public authorities, insurance and infrastructure industry, asset management and academia and finally launched the public consultation on the identification and calibration of infrastructure investment risk categories under Solvency II.

Our final advice on this issue will be submitted to the European Commission at the end of September 2015. When developing a favourable climate for long-term institutional investors in Europe, it is important to remember: if we create incentives that

are not properly aligned with risks, at some point in time we will see the emergence of bubbles instead of long-term investments. That is why the guiding principle of EIOPA's work is to build up sustainable long-term investments for the benefit of the European economy and EU citizens. We are ready to further discuss the issue and to contribute to its resolution.

But as a European Supervisory Authority we should not stop looking at the risks that long-term investments can also bear.

Building better portfolios: institutional investment asset allocation trends and the role of infrastructure

Raffaele Della Croce, Joel Paula

Institutional investors as economic actors

Institutions such as public pension funds, private pension funds, and public pension reserve funds occupy an ever-increasing role within the financial system. Not only do they provide income to beneficiaries and help to sustain standards of living for millions of people in retirement, but they act as important sources of investment capital and long-term financing. Given the increase in asset levels since the Global Financial Crisis of 2008, the accumulation of savings in such financial channels has never been larger. In order to advance the recovery to the next level, the challenge now is to put savings and financial liquidity to productive use in order to support sustainable growth.

But with financial markets strongly affected by policymakers' actions, investment paralysis – the problem of having few attractive opportunities in an environment where asset values already seem high is a challenge. To make it even more difficult, monetary and fiscal policies amongst the largest economies in the world are diverging, volatilities in currency markets are increasing and growth in emerging markets – long viewed as the future driver of global growth, has slowed.

The globalisation of investment programs has enlarged the opportunity set for institutional investors, yet the current macroeconomic environment renders traditional asset allocation policy inadequate to meet financial goals. Investors have responded according to several trends. The search for uncorrelated lower volatility returns, the expansion of alternatives, the optimisation of fixed income portfolios through diversification and yield enhancement, and revising asset allocation techniques were some key themes in institutional investment portfolios in the recent time period.

Besides the evolving institutional investment environment, the post GFC period is changing the way that financial institutions such as banks act as market makers and providers of credit. It is too early to predict the impact of Basel III, however, a shrinking capacity for banks to lend long-term implies that other sources of long-term capital will be needed. Institutional investors are increasingly stepping-in to provide long-term sources of finance, in some instances bypassing intermediaries altogether.

OECD Research on institutional investors and Long-Term finance

The recent OECD Survey of Large Pension Funds and Public Pension Reserve Funds reveals some emerging practices and trends that funds are using to adapt to the changing investment environment. With return expectations low in stocks and bonds, institutions are increasingly diversifying investments away from traditional categories. A salient trend over the past few years has been an increase in alternative investments. Allocation to investments such as hedge funds, private equity, and real estate is by no means a new trend amongst institutions. Some of the earliest investors began embracing alternatives in the 1990s. Yet evidence from the recent OECD Survey indicates increased allocations and interest in alternatives in the recent time period. This was especially true amongst the largest pension funds in the world: the top ten largest funds in the survey, representing USD 1.5 trillion in assets under management in 2010, increased alternative investment allocations from 17.6% of the total portfolio in 2010 to 19.5% in 2013, on average. This included increases in all major alternative investment categories.

Public pension reserve funds – a key investor segment of the survey – also increased alternative investments over the past four years from 10.5% to 14.7% on average. This figure in particular is a noteworthy shift in the investment posture of reserve funds, which back pay-as-you-go retirement systems and are different from funded pension schemes. Low bond yields and muted equity returns were again some of the major driving factors cited.

Infrastructure, which is often classified as an alternative investment, has more recently been part of this growing trend. Infrastructure is less mature and there are fewer funds that have exposure, however this is changing. Of the 71 funds that responded to the survey, 28 reported direct infrastructure exposure, defined as direct infrastructure funds, equity co-investment, or direct equity investment.

Five pension funds and one reserve fund indicated that they planned to increase target allocations to infrastructure in the next one to two years. Seven pension funds and three reserve funds reported that they planned to open new target allocations to infrastructure. Some funds also reported infrastructure debt exposure through project loans or bonds. Indeed, infrastructure is an asset category with many different risk return profiles. By investing in direct equity, mezzanine debt, and project loans or bonds, there is a spectrum of risk/return profiles that can meet various investor objectives.

Yet compared to other alternative investment categories, direct infrastructure comprised the smallest segment, occupying just 1.9% of the total portfolio of the top ten largest pension funds, on average. Looking at the entire survey population, representing USD 7.8 trillion in assets under management, on average just 1.0% was allocated to infrastructure considered as direct.

Policy implications

There is an opportunity for policymakers to seize on investment trends in alternatives and in particular infrastructure. But the right mix of market regulation and policy – both for the pension funds themselves, and in infrastructure markets is necessary. Barriers and disincentives which limit infrastructure investment need to be addressed. As seen in the survey there seems to be a large amount of potential capacity to expand

institutional investment in infrastructure, taking into account the target allocations of the funds that already have established allocations and those that are considering opening new allocations.

For example, Norway's Government Pension Fund Global, considered to be the world's largest sovereign wealth fund with USD 849.6 billion in assets at the end of 2013, announced in 2014 that it would research and consider adding infrastructure investments to the portfolio. Currently, the fund is not allowed to invest in unlisted infrastructure, per Norwegian statute. A panel of experts would review the possible addition of infrastructure, with a recommendation pending in 2016.

Japan's Government Pension Investment Fund announced a major change to its asset allocation which will include alternative investments such as infrastructure. Both of these funds are extremely large and reflect major changes in policy.

At a recent OECD roundtable on long-term investment policy, institutional investors in attendance cited three factors that present the main obstacles to infrastructure investment.¹ First was the lack of a transparent and stable policy framework; regulatory risk was a top concern. Government guarantees, credit enhancements, and long-term contracts are all risk mitigants to infrastructure investment, but investors need confidence that such institutions are here to stay over the life of long-term investment.

Second was a lack of bankable investment opportunities. Infrastructure investment funds have been gathering large amounts of capital commitments, yet liquidity remains on the sidelines due to a lack of attractive investment opportunities. Facilitating project procurement – like streamlining permits, or partnering with development banks to structure projects can help in this respect.

Third is a lack of transparent, quality data that describes the investment characteristics of infrastructure. Funds that are considering allocating to infrastructure have little to inform decisions. Due to data scarcity, confidentiality, quality and comparability, a lack of empirical evidence on the purported benefits of infrastructure in investment portfolios is a challenge. There are efforts underway to close this data gap; policymakers can play a role to facilitate this process.

Other important issues raised included clear and predictable accounting standards, long-term metrics for performance valuations and compensations, standardisation in project documentation, and transferability of loans and portability of guarantees. The expansion of financial instruments available for long-term investment (e.g. bonds, equity, basic securitisation of loans), and the need for a clear risk allocation matrix to assign the potential risk owner (i.e. government or investor or both) are also subjects to address.

Ultimately the primary concern for investors is the investment performance in the context of their specific objectives (such as paying pensions and annuities, or paying insurance claims). Infrastructure can become an alternative asset class for private investors provided that investors can access bankable projects and an acceptable risk/return profile is offered.

1. See the OECD LTI Project event page for further details.

Government action

Governments are responding to the need to invest for future growth. The G20's Brisbane Action Plan launched in December recognises that improving the domestic investment climate is "essential to attract new private sector finance for investment", highlighting the urgent need to address impediments to investment, such as FDI restrictions and market access barriers. At the same meeting G20 Leaders launched the new Global Infrastructure Hub, which will focus on project preparation and data collection and will be based in Sydney. This year, the OECD is working with the Turkish G20 presidency both to deepen and broaden the analysis on LTI financing developed under the previous Australian and Russian presidencies.

In Europe, the Juncker plan is also an example of government action addressing the infrastructure investment deficit. The stated objective of the plan is to leverage private sector capital, encouraging investment in infrastructure and SMEs. While much will depend on the specific choices being made regarding the project pipeline and the associated assistance programme, the specific focus chosen raises some doubts whether sufficient investors would be willing to contribute the substantial amount of funds that are expected to be coming forward from the private sector, without additional assurances. With the continuation of such policy work, governments can bridge the investment gap, laying more solid footing for a robust economic recovery.

The Obama Administration's Build America Investment Initiative is an interagency project designed to facilitate the mobilisation of private capital in infrastructure investment. Working with municipalities to design better PPP models, and also tailoring capital markets policy on the supply side has already borne fruit.

OECD Project on institutional investors and Long-Term investment

To this end, the OECD Long-Term Investment Project's programme of work is focused on building bridges between policymakers and long-term investors. For instance, forthcoming OECD research includes a comprehensive taxonomy for infrastructure financing that covers the wide range of both financing options and risk mitigation methods. This project in particular will provide policymakers with a policy framework to ensure project bankability by presenting the channels through which private capital can flow into long-term infrastructure. Risk mitigants and incentives described in the taxonomy ensure stability and support for nascent capital market formation in infrastructure finance.

OECD research on infrastructure as an asset class is closely related to the taxonomy and will help to close the information gap by analysing the existing literature on infrastructure investments, identifying data gaps that remain, and by describing a common thread that defines infrastructure for asset allocation purposes.

The ongoing G20/OECD workflow will advance the policy dialogue on institutional investment affairs. Planned events in the coming year such as the G20/OECD High Level Roundtable on Institutional Investors (in cooperation with the G20 under the Turkish presidency), and the OECD Annual Institutional Investors Forum will provide opportunities for institutional investors to gather and to advance this agenda.

OECD Work on institutional investors and Long-Term investment in the context of the G20

The OECD has been making contributions to the G20 through its project on “Institutional Investors and Long-Term Investment” (www.oecd.org/finance/lti), launched in February 2012. The aim of the project is to promote long-term investment (LTI), such as for infrastructure, addressing both potential regulatory obstacles and market failures.

The OECD is contributing to the G20 agenda on long-term investment financing through the G20/OECD Task Force on Institutional Investors and Long-Term Financing. In their November 2014 Brisbane Summit communiqué, G20 leaders prioritised work to “facilitate long-term financing from institutional investors”. Contributions by the G20/OECD Task Force on Institutional Investors and Long-Term Financing included:

- A report on the first set of Effective Approaches to Support Implementation of the G20/OECD High-level Principles on Long-Term Investment Financing by Institutional Investors, compiling a set of concrete actions member states are taking to implement the received High-Level Principles.
- The G20/OECD Checklist on Long-Term Investment Financing Strategies and Institutional Investors.
- An OECD report on Private Financing and Government Support to promote Long-Term Investments in Infrastructure.

Recognising that further research is needed and that institutional investors can play a role in promoting an agenda of economic stability and sustainable growth, further deliverables for the OECD related to this agenda will include:

- OECD research on the Taxonomy of Instruments and Incentives for Stimulating the Finance of Infrastructure, first presented to the G20/OECD Task Force in early September 2014.
- The results of the G20/OECD Checklist on Long-Term Investment Financing Strategies.
- A report on the remaining Effective Approaches to Support Implementation of the G20/OECD High-level Principles on Long-Term Investment Financing by Institutional Investors.

Other prospective OECD work in this area includes a report on the risk-return characteristics of infrastructure as an asset class and the continuation of the annual survey of Large Pension Funds investments under a G20 mandate, and the launch of the Large Insurer Survey which is designed to report on insurance companies as long-term investors.

The G20 Turkish Presidency and the OECD are also co-organizing the G20-OECD High-level Roundtable on Institutional Investors and Long-Term Investment – From solutions to actions: implementing measures to encourage institutional long-term investment financing in Singapore on 28 June 2015. Discussions focused on how policy makers and investors can facilitate private sector infrastructure financing, as well as issues risk mitigation and investment in developing countries.

Long-Term investment: a priority of the Italian Presidency of the EU

Fabrizio Pagani

Public investment in the future will be scarcely than in the past. That's just a fact. This leads to a two simple policy actions, if you want. We need 1) to facilitate private investment as much as we can; 2) to make better use of public investment. Public investment not only as avoiding waste, but making sure public investment as good leverage of the private one.

The issue of private investment is very much link to the question of the business environment. To facilitate a business environment which attracts investments including foreign investments is one of the flagship policy of the government.

It started with "Destinazione Italia" in the previous government it has consistent policy in this government to the competitive next degree and "Sblocca Italia" and lately with the budget law.

You can see the private investment from three angles. One is the issue of widening the number of originators. The only banks have good role to play, but we need to have actors behind banks.

For that reason insurance has to play a very important role. What we have done for example: we have allowed direct lending by insurance companies. It's not a easy area, but we know insurance companies which have interest to introduce direct lending, we have wide through regulation of the Italian insurance regulatory authority; the type of investment that insurance companies can do in the real economy.

In addition to insurance we have also given larger freedom and basically liberalized the credit market for credit funds, something which was not really possible before and we have also given fiscal incentives to remove barriers to credit funds which are now operating and we see as first result in the Italian market.

The second angle is the one of the tools we have put at DISPOSAL of the investors

In Italy was invented the new instrument of the mini-bond, something between corporate bond and private placement and we see positive result in that direction, although it's not penetrating very deep in the Italian economic structures but we see companies issuing mini-bond for more than 2 billions in the last week, this is a positive sign and with the number of successive riferiment we have very good legal framework in that sense.

Not only minibond, we also revised the frame of project bond and the number of majors to bring medium and small company close to the capital market. The Italian and European system is too based on banks and credits, we need to liberalized the credit market, we need to make sure that companies have the right tools the right incentives and they don't have to barrier the access of the market of capital. Minibond but also listing get to close to the stock market is one of the priority.

The third angle is the most innovative if you look at the perimeter which is reached by private investment. We sympathy with financial business. We see deeper in to the Italian economic system. Touching infrastructure and we see some first results in that sense PPPs? and in other areas we see in social infrastructures very important for private investment in valorization of the cultural and artistic legacy. So basically the perimeter is widening. It's not only because public investment is and we are drawing, but also because true private investment possibility is much wider. What's the rule of private investment? We know how to deal with public investment in one side and private investment on other side. The real difficulty is when you try to match the two. This is where the friction becomes very high and sometimes it becomes impossible to do project with the combination of the two.

Guarantee, PPPs... we're working around that. The key question is the private investment need to provide returns and guarantees etc. to be attractive investment. On the other side we have public administration in order to combine and to match the private needs. We are working with *Cassa Depositi e Prestiti e Fondo di Garanzia*, we have reviewed the PPPs.

The Juncker plan provides good opportunities to address this issues also in terms of bottlenecks at European level and national level; it's an exercise not to get money but also legal administrative and cultural infrastructure out of the plan.

Three priorities in Long-Term investing: jobs, capital and financing

Carlotta De Franceschi

1. Job is a very urgent matter. I love Juncker plan and all our discussion to focus very much on SMEs. SMEs represent the higher percentage of employment in Europe and at the moment they are suffering the worst credit crunch in Italy. So we need to support them with tool we have.
2. Capital. Two points here, a) sources of Capital and b) framework
 - a) Sources of Capital. We very much welcome the new directing of pension funds. The pension funds need to catch up with the frontier improving the governance and improving the skillset. They have to be able to compete with the Canadian and American pension funds and contribute with the real economy. And they can't do that if they don't really improve the professionalism. That's the only way they can really take care of pensioners.
 - b) Framework. That's most important thing for investments. We need to remove all uncertainties around tax, procedures or legal local framework and cut red tape. I feel Europe is very much bonded by red tape and that's one of the main concern of an investor.
3. Financing. Bank Regulation, that's the key point. In particular a) Bank financing, b) no Bank financing and c) guarantees
 - a) We lived in 2008 and 2009 what I think was an armageddon on capital markets. It was a wake up call for every body. And I guess the regulation was there to help restore the bank balance sheets. Banks are pretty much the most strategic asset that every countries has. And there is very closed link between the half of the government and the half of financial system. These two things are so interrelated and the contribution of the financial system to the economy is so crucial that we can't forget to put sustainability before stability because without sustainability we cannot achieve stability.
 - b) No bank financing. In the last two years credit funds raised roughly 350 billion US \$ there are cities where they are to be invested. European has to be more smart to create best frameworks to attract this funds. But it's not so smart now.
 - c) Guarantees. They are widely used in Europe. I wish the ABS program drafted by ECB. I wish we lived this, it's an opportunity to improve the local frameworks and boost so them so they can really support securitization and we can turn on a second engine that is very important for our financing and at the moment we we are flying with one engine only and it's a key to start the second engine.

PART II

RE-TUNING THE EUROPEAN PUBLIC-PRIVATE PARTNERSHIP AGENDA

Building growth in Europe: innovative financing for infrastructure

Paola Subacchi, Stephen Pickford, Davide Tentori, Helena Huang

Europe needs economic growth. The global financial crisis has exacerbated structural weaknesses on the supply side, has made the constraints imposed by the single currency even more stringent for euro area countries, and has led to a chronic lack of demand. To unlock the potential for long-term growth and job creation, this report suggests that there needs to be more and better investment in infrastructure.

The infrastructure shortfall in Europe is huge, from power generation and distribution to transport networks. It has been estimated that countries need around €2 trillion more investment between 2013 and 2020 than currently planned. And this shortfall is due to grow over time – to a total of almost €15 trillion up to 2030 – in the face of population ageing, environmental changes and the need to replace existing infrastructure. The stock of infrastructure also needs to be revamped. In most of the major countries the proportion of output spent on infrastructure has been on a declining trend since the mid-1960s. The financial crisis further contributed to this decline. In the EU, overall investment dropped sharply after the start of the financial crisis, from 21.3% of GDP in 2007 to 17.3% in 2013.

Low interest rates currently make liquidity abundant and borrowing relatively cheap. There is now a unique opportunity to harness cheap funding and use it for long-term projects. At the same time institutional investors, such as pension funds, with total assets of approximately \$75 trillion, are particularly interested in long-term investment with the potential to generate reliable multiyear revenues that would help them match their liabilities for pension payments.

An innovative approach to infrastructure projects, in terms both of policies and of financial instruments, has the potential to create a virtuous circle of stronger economic growth and job creation, improvements in productivity and enhanced financial stability. By updating existing infrastructure and investing in new, innovative projects, and by matching the duration of investment with its demographics, Europe has the opportunity to revive its economy and ward off the risk of ‘secular stagnation’.

Large infrastructure projects in Europe generate positive spillovers on job creation and productivity growth that transcend national borders. They are de facto pan-European because they employ materials, technology, machineries and people from different countries. Europe also needs more of these projects that cut across borders, such as better-integrated energy networks.

Of course, large infrastructure projects have often in the past been characterized by waste, inefficiency and in some cases corruption. Europe is littered with too many examples of ill-conceived, badly implemented and overspent infrastructure projects. Indeed one of the forces that contributed to the sovereign debt crisis was the misallocation of resources, notably in the south, towards excessive infrastructure investments, made possible by cheap financing. But bad past experience should not prevent Europe from finding new and better ways to finance and manage infrastructure investment in the future. Lessons need to be taken on board, and safeguards put in place to ensure that resources are directed towards projects with good returns.

Above all, the public sector should go back to taking a leading role on large infrastructure projects. Only the public sector can bear the ultimate risk involved in these projects. Innovative but complex projects such as the Channel Tunnel need an ‘owner of last resort’ that is prepared to recapitalize the project, if necessary, rather than letting it fail. Private investors do not have the time horizon or the financial capacity to step in, and their objectives are often not aligned with the public ones.

In addition, as described below, the EU and its member governments should pick up a part of the tab and help launch projects financed by jointly issued ‘eurobonds’. The return on well-selected and well-managed infrastructure projects is certainly higher than the current low return on risk-free financial instruments in an environment of abundant liquidity and under-utilized resources. If economic actors, both public and private, can be encouraged to take advantage of current conditions – where finance is relatively cheap and real resources relatively plentiful – to increase investment in infrastructure, this can create a virtuous circle and kick-start growth.

Policy recommendations to boost infrastructure investment within available financial resources

1. Develop a pan-European infrastructure strategy to encourage ‘good’ infrastructure investment, address constraints and remove bottlenecks.
 - Identify short-term and long-term priorities in a forward-looking approach. Countries should define priority projects, which focus on areas with a sustained impact on economic growth and the potential to enhance productivity.
 - Improve the regulatory framework and provide better financial ‘instruments’ – assets, sources and vehicles – to encourage greater investment and make better use of the existing financial resources.
 - Encourage the right choice of projects. In order to avoid inefficiencies and waste of financial resources, and to create a comprehensive pipeline at the EU level, a better mechanism for project selection needs to be designed on the model of the UK’s National Infrastructure Plan.
 - Projects submitted by member states to the European Commission should be selected through a bottomup approach and on the basis of criteria such as transnational dimension, size, sectors with high technological intensity and: priority should be given to sectors with high technological intensity, and economic return.

2. Create a European Infrastructure Agency to be responsible for the coordination and implementation of the pan-European infrastructure strategy. This agency should work in collaboration with the G20, the World Bank and the regional development banks as well as with the European Commission, the EIB and the EU member states to exchange information and best practice, set up a pan-European database of projects and assist investors to seek projects relevant to them and to compare them across different countries.
3. Foster effective collaboration between the public and the private sector. If Europe has the ambition to lead again on innovation and competitiveness, then a good 'mix' between public and private participation needs to be devised. For example:
 - the public sector should play a key role at a project's initial stage: it should set priorities, provide a transparent procurement procedure, offer initial financial support, provide guarantees and smooth risks;
 - public-private partnerships (PPPs) should be encouraged. A European PPP Expertise Centre should be created as a joint initiative by the European Investment Bank (EIB) and the European Commission to share experience and expertise, analysis and best practice relating to all aspects of PPPs. Procurement procedures should do better at specifying the costs and risks of projects in order to avoid delays and extra costs. There should also be more transparency on the returns made by equity investors;
 - additional upfront guarantees from the public sector should provide support throughout their life-cycle for large projects with higher risks but high public benefits. When a project runs into difficulties, the public sector should step in and take ownership of the asset.
4. Promote a well-functioning market and implement policies that aim to match supply and demand of capital. These include:
 - reviewing the rating criteria for investors, which currently favour financial assets with short-term maturities. For instance, speculative-grade short duration loans (rated 'BB+' and below) currently require less capital allocated by insurers than a four-year 'BBB+' or eight-year 'A+' project investment;
 - facilitating access to long-term investment funds. The European Commission roadmap of March 2014 suggests new ways to unlock long-term financing to meet the needs of the European economy;
 - fostering coordinated action by national governments. The political groups in the recently elected European Parliament should make this issue a priority on their agendas, communicating this also to MEPs' national capitals.
5. Improve the allocation of Structural and Cohesion Funds in order to tackle inefficiencies, leverage up the resources available and create incentives to choose the right projects by:
 - providing EU funds only to projects included in the European pipeline in order to improve resource allocation;
 - ensuring support, advice and due diligence so as to reduce inefficiencies;

- reducing the proportion of co-financing by making more European resources available. The European Commission could use Structural and Cohesion Funds to fund a small portion of the total costs, with the bulk of the financing covered by loans from the EIB and national development banks. These institutions could pool their available resources by issuing euro-denominated securities for investment in infrastructure projects;
 - reducing political interference at the regional/ local level in the definition and management of infrastructure policies through a due diligence process undertaken by the EIB, so as to assure investors about the strength and stability of the country-specific regulatory frameworks.
6. Promote the use of project bonds to fill financing gaps in the riskier stages of infrastructure projects undertaken by the private sector and included in the European pipeline. Resources available for the EU 2020 Project Bond Initiative, carried out by the EIB and currently in its pilot phase, should be increased. The Project Bond Initiative should be strengthened through:
 - broadening the pipeline of suitable projects and focusing on bridging the gap between debt and equity capital to help projects develop through their riskier stages. Resources could be pooled with national development banks, such as Cassa Depositi e Prestiti, Caisse des Dépôts et Consignations, Kreditanstalt für Wiederaufbau, Instituto de Credito Oficial, PKO Bank Polski;
 - issuing European-backed bonds (or ‘eurobonds’) with long maturities for infrastructure projects. Since issuing Eurobonds fully backed by all EU member states is still a sensitive political issue, bonds could be jointly issued by national development banks together with the EIB. These hybrid bonds would be transnational and jointly guaranteed by participating national governments, making them more attractive to investors.
 7. ‘Bundle’ smaller projects that cannot reach a dimensional threshold, such as social infrastructure projects, in an ‘aggregator’ – a pooling vehicle which can help obtain finance. The EU aggregator could be modelled on the UK experience, where the Priority School Building Programme is now financing renovation works of 215 schools with a funding requirement of £700 million.
 8. Promote higher infrastructure investment in countries with wider fiscal space. Germany, for instance, requires investment to upgrade and modernize its infrastructure and has the necessary fiscal capacity to undertake more ambitious investment programmes.

The FeBAF decalogue: ten proposals for a leap forward in financing infrastructure

Italian Banking Insurance and Finance Federation

Infrastructure Investments are a key element for a medium/long-term strategy to relaunch sustainable growth in Europe. Infrastructures are indeed a fundamental driver of GDP and employment growth, contributing in the long-term to increasing productivity, lowering production costs and stimulating innovation.

The Italian Banking Insurance and Finance Federation (FeBAF) has established a Working Group on long-term investment in Europe, coordinated by Prof. Rainer Maserà. Through this Group, Febaf responded to the Public Consultation on the European Commission's Green paper on the long-term financing of the European economy. Furthermore, the Federation has sponsored the Chatham House Report "Building Growth in Europe. Innovative Financing for Infrastructure", released in October 2014 in Rome.

As highlighted in the Chatham House Report, the infrastructure shortfall in Europe – from power generation and distribution to transport networks, harbours, railways, highways, airports – is huge: it was estimated that Europe needs around 2 trillion Euros worth of additional investment up to 2020, and almost 15 trillion before 2030. Moreover, population ageing, climate change and infrastructure obsolescence are worsening the gap between Europe and other advanced economies, and increasing new infrastructure demand.

The need for focusing on investment is well understood and recognised in Brussels: the new President of the Commission, Jean-Claude Juncker, has issued a plan for 300€ trillion for the next 3 years, relaunching the role of the EIB.

Italy suffers of an additional gap, within the broader European gap: we register a chronic delay in relation to other major European economies in terms of fixed, network and social infrastructure. This gap is becoming increasingly serious, due to old and inadequate establishments, lengthy bureaucratic procedures and lack of expenditure capacity. Adding to this state of affairs the inadequate use of European structural funds, there emerges another significant gap, an internal gap within Italy, that between North and South.

This is why Febaf, on behalf of the Italian financial community, has proposed a set of ten priority actions, that we believe are necessary to relaunch investment in infrastructure in Europe as a core element of a wider growth and employment strategy. Europe can, and should, create a virtuous circle of investment and competitiveness, capable of

kick-starting a new phase and more robust model of growth and employment creation, to be benefit of savers investors and the European economy.

- 1) Define a pan-European infrastructure strategy, involving the European Parliament and member states in a wide and comprehensive consultation process of all the relevant stakeholders (Green Paper and Action Plan).
- 2) Create a European Infrastructure Agency with the aim of establishing a “Single Rulebook” and a “Single Supervision Mechanism” on infrastructure investment. This implies transferring the relevant prerogatives from the national to the European level (i.e. a European system of national infrastructure investments authorities), and giving the new Agency expenditure and project management functions (similar to the Single Mechanisms that were created for the Banking Union).
- 3) Establish a European Public Private Partnership (PPP) Expertise Centre to share innovation experiences and expertise among public and private players. This centre could be established within the Authority under 2.
- 4) Improve flexibility in the use of European Structural and Cohesion Funds in support of investment and the stabilisation of the economic cycle.
- 5) Eliminate or reduce co-financing requirements and constraints. Ensure and define infrastructure management and financing policies between the regional/local level and the European level.
- 6) Improve the use of project bonds and Eurobonds (as issued for instance by National Development Banks), moving on from the pilot phase to current operations, mobilising a critical mass of adequate resources.
- 7) Promote the use of ELTIFs, Long-Term Investment Funds.
- 8) Support and speed up the process towards the Capital Markets Union; promote the development of an effective securitisation market, the use of debt funds, private equity and venture capital, the role of institutional investors. A developed and integrated capital market in Europe can provide a significant contribution to infrastructure investment.
- 9) “Bundle” smaller projects that cannot reach an adequate dimensional threshold, such as often social infrastructure projects, in an “aggregator” vehicle, which can help obtain more and better finance.
- 10) Promote a fully-fledged “Infrastructure and Investment Union” in Europe, to the advantage of European citizens, savers and businesses.

Action plan for the development of project financing: 12 recommendations

Henning Christophersen, Kurt Bodewig, Carlo Secchi

Assistance for project pipeline, identification and financial structuring

1. **Member States'** administrations should have unimpeded access to dedicated technical assistance, in particular through the European Investment Advisory Hub which is an integral part of the European Fund for Strategic Investment (Juncker Plan), in order to undertake the following three goals: first, support the activities for the development of a stable **pipeline of mature projects**, encouraging investors to engage in transport infrastructure; secondly, help identify projects that could use project finance and thirdly, provide advice, when necessary, for the adaptation of the procedures and the legal framework. The existing and future support schemes, for instance at the national level, should also be mobilised towards these goals. This dedicated technical assistance should also include support dedicated to generating a better understanding of the Public Private Partnership (PPP) schemes and to mastering risk-sharing techniques.
2. **Project Promoters** should include and pay, in the project preparation process, due consideration to the **projects' life-cycle** from project conception to development and implementation, including the costs and all other relevant issues linked to their maintenance. **Maintenance** activities and costs should be carefully planned and included in the project financial structure in order to ensure full functioning of the infrastructure in its entire life-cycle and avoid future budgetary issues.
3. **Member States and project promoters** should work together and obtain support for improving the **quality of projects** in order to facilitate their development and make them attractive to investors. As part of the projects' quality, attention should be paid to the contractual arrangement and appropriate risk-sharing between public and private partners when appropriate.

Dedicated **technical assistance** should be made available to project promoters and other stakeholders for the project preparation, in dealing with environmental aspects, as well as, when appropriate, for financial structuring and procuring projects as Public-Private Partnerships (PPPs) and Project Finance and for setting up Special Purpose Vehicles. As-

sistance should also be considered to support European, national or local authorities in the setting-up of dedicated investment platforms (on a sectoral or geographical basis). The European Investment Advisory Hub and national advisory and training structures should focus on these activities.

Procurement, permitting and state aid consistency

4. **Member States** should streamline, adapt and thus simplify their **procurement procedures** in order to accelerate the implementation of projects and facilitate the use of alternative financing models, in line with EU legislation. Specific issues related to the procurement of cross-border projects should be addressed by the **European Commission**.
 - a. It is worth exploring systematically the use of PPPs and concessions to manage projects' life-cycle with a substantial risk transfer; the sharing of best practices and capacity building, the set-up of dedicated structures to provide standardised methodologies for risk mitigations and transfer (contracting), competitive dialogue with tenderers, gate-keeping, and advice. In this perspective, the European Commission and the Member States could develop a framework for the **cooperation between public authorities and private co-investors**, including as regards their respective role in the management and ownership of the infrastructure.
 - b. On **cross-border projects**, a single legal framework has to be favoured over the coexistence of multiple national systems. Notwithstanding the progress made by the current EU rules (23-25/2014), self-executing guidelines to be applied "off-the-shelves" could significantly reduce uncertainties and reduce their time-to-market. A simplifying feature could be the use of a single language in tender and contracting documents (with the agreement of the parties involved and independent from the choice of the project's legal seat). Besides, the choice to publish a tender either at the project's legal seat or at the place where the activities occur should be given to cross-border projects.
 - c. Procurement guidelines for cross-border projects (on legal seat, language regime, dispute settlement procedures...) should be elaborated at EU level in order to simplify procurement procedures and to reduce inherent procedural risks.
5. **Member States** should streamline and thus simplify their **permitting procedures** in order to facilitate and accelerate the implementation of projects, in line with EU legislation. The specific issues related to the permitting procedures for cross-border projects simplification ought to be put forward by the European Commission. A fine-tuned procedure for environmental appraisal and permitting would prove useful, for instance by:
 - a. Setting-up a single contact point ("one-stop-shop") for applying for a project, notably important for cross-border projects, streamlining the different national / regional rules on the base of the EU requirements.

- b. Streamlining and aligning in time the different procedures (Environmental Impact Assessment, Natura 2000 Directives, Water Framework Directive), benefiting from the information of comprehensive Environmental Impact Studies, gathering all the national/local authorities together in a single forum in a coherent and timely manner.
 - c. Anticipating relevant studies at an early stage in order to avoid impacting the procurement / financial structuring phase, thus curbing risks and public liabilities.
 - d. Restricting conditions leading projects to a standstill in case of appeal, and foreseeing their time-effective and efficient treatment; planning swift procedures to surrogate a non-compliant contractor in case of irregularities or difficulties.
6. The **European Commission** should ensure that **state aid rules** will be conducive for the use of EU financial instruments and for national support to infrastructure of European added value. Certainty should be given as early as possible to project promoters and investors as regards the consistency of ESIF supported projects with the rules, and compliance of any Members States co-financing; notably:
- a. A “single window, fast-track clearance procedure” for notification of grants and other national support schemes linked to the implementation of the financial instruments under the European Fund for Strategic Investments (EFSI) and Connecting Europe Facility (CEF); this would lead to an ex-ante clearance concerning the state aid compliance, thus avoiding any legal risk.
 - b. The financial instruments managed by the EU, such as the CEF Debt Instrument and the EFSI guarantee, should be considered fully consistent with state aid rules as they are offered with transparent and open procedures by the EIB to all market players, since market failure has been substantiated by ex-ante assessments.
 - c. Clarification on state aid rules for cross-financing of projects ought to be provided by the Commission services.
 - d. Provided that the Member States co-invest in projects under the same conditions as the EFSI, and projects are selected by the EIB, also the national support should be considered state aid consistent.

Broadening funding and financing

7. The **European Commission** should propose a framework to **find additional resources** for projects of EU added value in a comprehensive and multimodal setting, for instance through the earmarking of revenues and cross-financing solutions:
- a. “Polluter-pays” and “user-pays” principles should be more widely applied to reduce the burden borne by tax-payers for the construction and maintenance of infrastructure, as a way of eliminating distortion induced by asymmetric and inefficient taxations across transport modes, to promote more energy-efficient structures generating external benefits.

- b. For very large infrastructures with long implementation time and low direct financial return, it is worth exploring the possibility of establishing an “infrastructure fund-like” mechanism for their development and exploitation.
8. The **European Commission** should propose a framework to find additional resources for projects of EU added value through an improved implementation of the user-pay principle. This can be achieved by calculating more accurately the external costs and by monetising the external benefits induced by the development of infrastructure.
Tools such as Eurovignette or the Emission Trading Scheme (under a potential widened scope) could be implemented in such a way as to make funding available for projects generating positive externalities.
9. The **European Commission** should facilitate the **blending and pooling** by combining the grants from the Connecting Europe Facility (CEF) and the European Structural and Investment Funds (ESIF) with the financial instruments and products available under the CEF and the European Fund for Strategic Investment (EFSI):
 - a. Financial instruments should be adapted to the needs of infrastructure sectors, the size of projects or geographical markets, and any other relevant features arising from the market needs. The assessment of specific market barriers would therefore facilitate the take-up of the financial instruments.
 - b. Consideration should be given to developing, when appropriate, financial instruments that can better address project diversity regarding their size and risk. This involves the development of financial instruments for aggregation of small projects in order to target a large number of stakeholders at once within a market segment, and financial instruments maximising the benefits of risk diversification within portfolios of projects at EU level and across sectors and modes of transport.
 - c. The Commission should reinforce the use of its right of scrutiny of the requests for grant support for revenue generating projects, for instance for Major Projects under ESIF, to better advise project promoters and shift to a more efficient use of grants combined with financial instruments.
Financial regulation and budgetary accounting of PPP Stakeholders’ involvement and Communication
10. The European Commission should ensure that possible unintended impacts of the Regulations on financial markets, such as Solvency 2 and Basel III, on infrastructure long-term financing are mitigated, notably through:
 - a. The creation of an asset class category, notably for infrastructure projects supported by the EU: the category would cover key European projects (CEF and EFSI-related) for which economic viability is proven.
 - b. Taking into account, inter-alia, the low risk and high recovery rate recorded in past years of project finance compared with corporate finance loans, a revision of the risk weight provisions for project finance in the financial prudential regulations ought to be considered, at least for EU-backed projects.

- c. Noting the interest of the public sector for the performance of PPPs and for the continuity of the public service these projects can ensure, a favourable treatment could be sought also in the absence of an explicit public guarantee.
11. The European Commission should propose a clear and incentivising statistical treatment of PPPs to acknowledge their contribution to growth, and provide certainty to project promoters and investors as early as possible when preparing the projects, in particular on the inclusion of the incurred debt under the Stability and Growth Pact. Considering the pivotal role of public guarantees to achieve an adequate leverage, the following elements need to be explored:
 - a. Off-balance-sheet treatment of EU guarantees, including from EIB / other financial facilities.
 - b. Defining ex-ante schemes of contracts involving national guarantees (including from national development banks) that can be kept off-balance-sheet.
 - c. Conditions for limiting the inclusion in the national debt/deficit to the sole cost of the guarantee.
12. The European Commission and the EIB should ensure in a joint effort a wide consultation with all the interested parties (project promoters, national promotion banks, commercial banks, institutional investors) on the financing of transport infrastructure, in particular for the exchange of best practices, the promotion of financial instruments or dedicated financial schemes, and provide regular information to the Member States and to the European Parliament.

This calls for a structured cooperation and consultation between the EU actors (notably the services of the Commission and the EIB), with early screening of the potential projects and an open dialogue with project promoters.

More generally, the know-how of local, regional and central administrations of the existing legal framework for project preparation, including for procurement and state aid, should be improved through dedicated and regular training programmes offered by the European Investment Advisory Hub and national advisory and training structures.

Finally, an appropriate and effective Communication policy and initiative should be intensified to the benefit of a better understanding and involvement of the general public.

Focus on energy and transport networks

Giovanni Gorno Tempini

European networks overview

Infrastructure investments are essential to build long-term growth. In particular energy and transport infrastructure play a crucial role in the integration and efficiency of the European Union's (EU) internal market and they are central to the EU's strategic transformation towards a low-carbon and more integrated economy over the medium-long run.

According to IMF (September 2014), increased public infrastructure investment raises output in the short term by boosting demand and, in the long-term, by raising the economy's productive capacity. In a sample of advanced economies, an increase of 1% of GDP in investment spending, raises the level of output by about 0.4% in the same year and by 1.5% four years after the increase. In addition, the rise in GDP offsets the increase in debt, hence the public debt-to-GDP ratio decreases. This means that public infrastructure investment could pay for itself.

A recent S&P study¹ has also outlined that an increase in spending of 1% of GDP, would have a multiplier effect (2015-2017) in the Eurozone of 1.4 (UK 2.5, Italy 1.4, France 1.4, Germany 1.2,) with 627,000 projected job gain.

Developing networks, creating a smooth European system by linking regional and national infrastructure will promote interoperability, social integration, development in weaker regions, efficient and sustainable energy production and will increase competitiveness putting Europe firmly on the path of economic recovery.

Connecting Europe is the heart of the EU mission: as of January 2014, the so called Connecting Europe Facility ("CEF")² dedicated to Trans European Network

1 Global Infrastructure Investment: Timing is Everything (And Now is the Time) – January 2015.

2 The CEF financial support is provided mainly through two forms: grants, and contributions to innovative financial instruments, developed together with entrusted financial institutions as the European Investment Bank ("EIB"), such as: the Marguerite Fund, the Loan Guarantee for TEN Transport ("LGTT") and the Project Bond Initiative.

(“TEN”), with a budget of approximately € 33 bln³ up to 2020, aims exactly to accomplish synergies in the different sectors enhancing the Union’s efficiency and leveraging funds from both public and private sectors⁴.

Completing European integration in the expansion of energy and transport and telecommunication networks will bind together the economies of Central Europe with the rest of the European Union, increasing overall productivity and competitiveness.

The availability and quality of infrastructure still varies remarkably across the EU. The gap (which has anyway reduced during these last years) in the quality and availability of infrastructure in old and new Member States, reflects the development of these countries. In some older Member States, the infrastructure assets have remarkably deteriorated due to the ageing of networks and low maintenance.

In the core countries of the Euro area, studies show low new investment for roads and rail. Just outside this perimeter there seems to be a transition after a period of high investment in roads. In the newer Member States, investment has been higher than expected, with a significant increase in investment, which reveals their eagerness to catch up with the rest of the EU. However in most of these countries, the stock of infrastructure is still lower than the EU average.

On the other hand, investment in energy across the EU has been quite intense in most Member States, reflecting the shift to renewable and low-carbon energy encouraged by the EU’s climate and energy strategy.

However, despite the great effort made in completing European networks during these past years, cross-border transport and energy connections, remain anyway inadequate, particularly for railways and electricity.

It is therefore crucial to progressively replace the existing patchwork of fragmented projects with an efficient and sustainable pan-European network through the identification and implementation of projects with a high European added value.

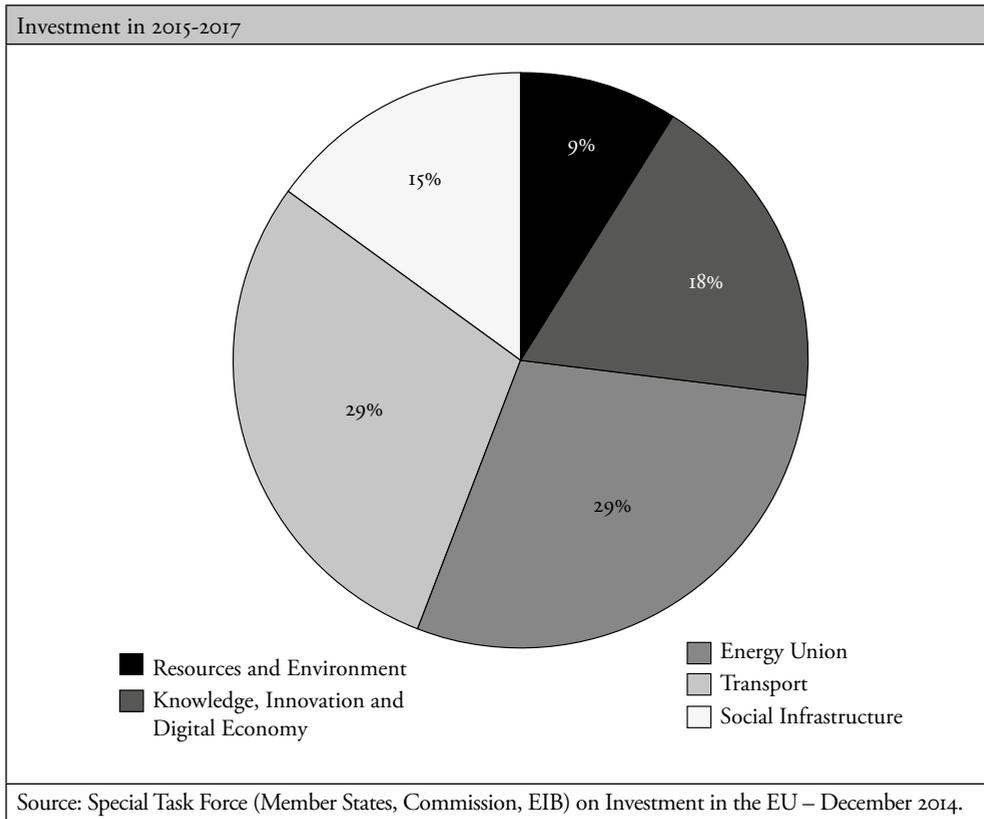
In December 2014, a EU Special Task Force⁵ has identified a list of projects⁶ that could be implemented over the next three years. The projects were identified by the Member States according mainly to 3 criteria: EU added value; economic viability and expectation that capital expenditure will incur in the period 2015-2017. The list include over € 500 billion of projects, totaling approximately € 1.3 trillion of potential investment. Transport and Energy represents the biggest chunks of investment (both with a share of 29%) among the listed sectors.

3 Out of € 33 bln, € 3.3 bln will be used to back the 16 bln guarantee of the European Fund for Strategic Investments (EFSI).

4 CEF provides supplementary resources to projects being implemented under the well-known European Structural and Investment Funds (“ESIF”).

5 Special Task Force (Member States, Commission, EIB) on investment in the EU – December 2014.

6 The report specifies that the list could not be exhaustive.



European Transport Sector at a glance

Investments Needs for TEN-T: € 1.5 trillion up to 2030 (€ 550 until 2020)

The transport industry:

- represents 4.6% of GDP
- accounts for 4.5% of total employment

Total Value of PPP transactions closed in 2014: € 11.8 bln (2/3 of the Total Market)

Budget allocated under the CEF from the EU to co-fund TEN-T Projects: € 26.3bln up to 2020.

Main Investment opportunities drivers

- Road access pricing
- Congestion Management
- Highways concession model
- Upgrade of rail networks and rolling stock

Transport sector – Highlights

The transport industry employs more than 10 mln people, accounts for 4.5% of total employment, and represents 4.6% of GDP⁷.

Since the mid-1990s, the development of road infrastructure has increased significantly and in some cases has exceeded the growth in road traffic (freight and passenger).

Railway infrastructure has grown more slowly as trains have been losing market share in both passenger and freight traffic. In 2014, the aggregate value of PPP transactions which reached financial close in the European market, totaled to € 18.7 bln, a 15% increase over 2013 (€16.3 bln)⁸ with 82 projects.

The transport sector remained by far the most active sector in value terms. With € 11.8 billion worth transactions, transport represents two third of the total market value. The number of deals closed in the sector increased to 23 (from 16 in 2013) making transport the most active sector in terms of number of projects also.

Although the transport sector seems to be very active in Europe, high investments are required to achieve a reliable and efficient network which is essential for the internal market and economic activity in the EU.

Currently the transport infrastructure network is highly fragmented with a remarkable lack of multimodal connections. The EU TEN-T program aims to close these gaps between Member States' networks, remove hurdles that still affect the free functioning of the European market and overcome technical barriers due to the incompatible standards for railway traffic.

The Commission estimates that EUR 1.5 trillion is required for TEN-T infrastructure investment up to 2030⁹. (€500 bln until 2020 out of which some €250 bln can be referred to the removal of the main bottlenecks) while the budget allocated by the EU, under CEF, to co-fund TEN-T projects, is €26.25¹⁰ bln up to 2020. Of this amount, €11.3 bln will be available only for projects in Member States eligible for the Cohesion Fund¹¹.

Nine core network corridors have been identified, together with 30 priority projects which were selected according to their added value for TEN-T development, sustainable transport and their maturity status. The list highlight a great focus on railway projects (60% of the projects) and on motorways of the sea showing the remarkable focus of the EU to support a sustainable development.

In order to increase multimodal connections, the EU required that each core network corridors include three modes, in addition to three Member States, and two cross-border sections. Out of the nine core network corridors, seven have a real east-west dimension.

7 Special Task Force (Member States, Commission, EIB) on Investments in the EU – December 2014.

8 Review of the European PPP Market in 2014 – EPEC.

9 Special Task Force (Member States, Commission, EIB) on Investment in the EU – December 2014.

10 See footnote no. 4.

11 EU.

Corridors:

- The Scandinavian-Mediterranean Corridor
- The North Sea-Baltic Corridor
- The North Sea-Mediterranean
- The Baltic-Adriatic Corridor
- The Orient/East-Med Corridor
- The Rhine-Alpine Corridor
- The Atlantic Corridor
- The Rhine-Danube Corridor,
- The Mediterranean Corridor

Priority Projects:

30 priority projects, which have significant size or crucial importance, have been selected. The projects focus on the need for sustainability: 18 are related to rail, 3 are mixed rail-road and 2 are waterways. The “Motorways of the Sea” initiative, (which is vital for reducing the negative environmental effects of freight transport) entered the TEN-T list as a priority project.

So far out of the 30 priority projects, 5 have been completed.

The core network will improve connections among: 94 main European ports with rail and road links; 38 key airports with rail connections into major cities, 15,000 km of railway line upgraded to high speed, 35 cross-border projects to reduce bottlenecks.

The goal is to ensure that, by 2050, the great majority of Europe’s citizens and businesses will reach the comprehensive network in less than thirty minutes’

By 2050, through the integrated network of transport corridors, European freight transport is expected to grow by 80% and passenger transport by more than 50%.

It is interesting to mention that studies outlined the positive result of investment in TEN-T infrastructure for individual Member States and regions. For example, it has been calculated that an investment of € 10 bln (present value 2010) in the Danube-Axis will create a GDP-effect in Austria of approximately € 23. bln for the period 2010-2050, creating 10.000 jobs. For the whole European Union (excluded Austria) the GDP-effect will be around 50 billion Euros, with a creation of 75.000 sustainable jobs¹²

Transport investments should also contribute to achieve the goal of reducing greenhouse-gas emissions (in transport) by 6% by 2050.

The EU has also set two horizontal priorities regarding the European Rail Traffic Management System –“ERTMS” (the interoperable rail signaling system chosen for European Union) and Motorways of the Sea (MoS).

Despite the intensive work made so far, there are still many challenges that need to be addressed including: missing links especially at cross-border sections, remarkable

12 Attracting investments – Towards transport infrastructure – Potential lines for action – European Commission September 2014.

differences in the quality and availability of infrastructure within the Member States (in particular East-West connections require improvement, or upgrading of existing infrastructure), shortage of multimodal capacity and existence of differences on operational rules which makes difficult to achieve an integrated market.

Energy sector – Highlights

European Energy Sector at a glance

Investments needs in the EU Energy Sector: € 1 trillion by 2020

Budget under the CEF: approx. €5.85 bln for the period 2014-2020.

Main Investment opportunities drivers

- Climate change & EU 3rd energy directive
- Security of energy supply
- Unbundling
- Non-core utilities portfolio sales
- Utility balance sheet deleveraging
- Future maintenance & growth capex

It is crucial to set up a strong Energy Union with a forward-looking approach regarding security, climate change policy and sustainable development. Shifting to a low-carbon market and meet the EU medium term and long-term targets for greenhouse gas reduction, share of renewable energy consumption and improvement in efficiency can't be further procrastinated.

Europe energy landscape is changing quickly. Today, renewables represent 25% of the EU's electricity supply and this level could rise to 50% by 2030. Renewables require more grid flexibility, new approaches, new technologies and new markets. Innovative smart grids will therefore play a primary role for the development of the Energy Union. They will ensure that energy supply can always meet demand, but, at the same time, in order to reduce costs, the flowing will occur only when needed. Smart grids could also reduce the infrastructure capacity needed by up to 30%.

Reaching the targets and achieving an energy union will reduce dependence on single suppliers, will increase efficiency and bring to a more competitive market.

In an Energy Union, citizens are of remarkable importance. The prices they pay should be affordable and competitive with more competition and choice for every consumer. An efficient European energy grid could save consumers up to €40 bln a year.

With an energy union, Europe will be less dependent from non- European countries and this will assure more predictability which it is crucial for investors.

Currently the EU is importing 53% of its energy, at an annual cost of around €400 bln resulting the largest energy importer in the world. The Commission has estimated that over €1 trillion needs to be invested into the EU energy sector by 2020.

Since 2008, the EU set an ambitious policy agenda for energy with three targets for 2020: a 20% reduction target for greenhouse gas emissions, a 20% share of renewable energy as part of the energy consumption and 20% energy efficiency improvements.

It is estimated that approximately €205¹³ bln are needed per year up to 2020 to replace ageing infrastructure and achieve the 2020 climate and energy targets. In October 2014, the European Council agreed on new energy and climate targets to be reached by 2030¹⁴. In order to make these policies cost effective, it is estimated that investment will be considerably high at around €209¹⁵ bln per year for the period 2021-2030. These figures include investment in the power, building (residential and tertiary) and industrial sectors, and covers replacement needs and additional needs due to the higher policy goals.

The EU has estimated that approximately €200 bln is needed up to 2020 for transmission grids and gas pipelines.

The expansion of electricity infrastructure has increased in line with electricity consumption. However additional investment in cross-border energy infrastructure is needed to improve the EU's energy security and the well-functioning of the energy market. Gas infrastructures (storage, pipelines, interconnections, and LNG terminals) will expand in the next years, driven by expected growth in demand together with the decrease in domestic production (especially in North Europe). Europe urgently needs to upgrade its infrastructure to accommodate changing supply flows: long-haul pipelines need to be developed, together with additional LNG terminals and new storage facilities. Renewables installed capacity is also expected to grow distinctly by 2020. It has been recorded that 75% of EU housing stock is energy inefficient; 94% of transport relies on oil products, of which 90% is imported. Moreover wholesale electricity prices in Europe are 30% higher, and wholesale gas prices over 100% higher, than in the US. The new EU guidelines for Trans European Networks in the Energy Sector ("TEN-E"), set in 2014, stress the importance of facilitating and speeding up the completion of projects. The EU under the CEF has made available approximately € 5.85 bln¹⁶ up to 2020. Only a small number of infrastructure projects (which are not commercially viable, but are necessary because of the externalities they provide) will need grants under the CEF. Many other projects could make use of other financing methods (always under the CEF) that provide more leverage than the grants. Additional funds may come from Structural Funds or other EU instruments. The EU has identified a number of priority corridors under its Trans-European Networks (TEN-E) strategy in order to support construction and funding of important energy infrastructure. These corridors require urgent infrastructure development in order to connect EU countries currently isolated from European energy markets, intensify existing cross-border interconnections, and help integrate renewable energy.

13 European Economy – Occasional Paper 203 – December 2014.

14 Target for 2030: 40% cut in the greenhouse gas emissions compared to 1990 levels; at least a 27% share of renewable energy consumption, a 30% improvement in energy efficiency (compared to projections) – EU 201.

15 European Economy – Occasional Paper 203 – December 2014.

16 See footnote no. 4.

EU priority corridors for electricity:

- Offshore grid in the Northern Seas and transmission lines to Northern and Central Europe to transport power produced by offshore wind to consumers and energy storage centers
- Transmission lines in South Western Europe such as between Spain and France to transport power between EU countries
- Transmission lines in Central Eastern and South Eastern Europe to strengthen the regional network
- Integration of the Baltic electricity market – Lithuania, Latvia, and Estonia – with the rest of the EU

EU priority corridors for gas:

- The Southern Corridor to deliver gas directly from the Caspian Sea to Europe
- Integration of the Baltic gas market and connecting it to Central and South East Europe
- North-South gas pipelines in Western Europe to remove internal bottlenecks and enable the best use of possible external supplies
- North-South gas pipelines in Central Eastern and South Eastern Europe including regional connections in the Baltic Sea region, the Adriatic and Aegean Seas, the Eastern Mediterranean Sea, and the Black Sea, to help diversify gas sources and increase security of supply

EU priority corridor for oil:

Improving interoperability in the oil supply connections in Central Eastern Europe to increase security of supply and reduce environmental risk

Project of Common Interest (“PCIs”)

Based on the priority corridors, the EU draws up a list of 248 PCIs. The list is updated every two years. The projects selected can take advantage of a number of benefits including faster permitting procedures and applying for funding under the CEF. A total of € 650 mln grants is planned for PCI's in 2015 with the first two proposals.

Evolution of the market

It seems that Europe is emerging from the economic crises, however compared to other major economies and the previous recession in Europe (93-97), the pace of the EU recovery is still slow.

Total investments in the second quarter of the 2014 have dropped by around € 430 mln in comparison to the 2007 figure (- 15%)¹⁷. Despite the current situation, by the end of 2014, the EU Special Task Force has estimated the investment potential to be around € 1.3 trillion of which approximately € 760 bln for Transport and Energy Union.

17 An Investment Plan for Europe – November 2014.

At the same time, there has been a sudden recover of liquidity and there is a clear trend towards stronger involvement of the private sector to finance infrastructure. EPEC has recorded a 15% increase in 2014 over 2013 in the aggregate value of PPP transactions in Europe¹⁸.

Notwithstanding the positive developments, the available liquidity is not reaching the real economy. Unfortunately the funding gap still exists. The gap seems to have transferred from a shortage of debt to a shortage of viable projects. Why is that?

The true is that during the crises the market has remarkably changed. Before 2008, in addition to banks loans, large European infrastructure projects issued debt to institutional investors. Bond transactions were mainly monoline wrapped.

The monoline guarantor not only gave credit enhancement to the project company, but also played the role of controlling creditor during the construction period. This structure overcome two main problems related to institutional investors: the decision making issue linked to their typical passive approach and the lack of expertise of their investor teams which, often, are not familiar with project risks. On the contrary those problems have never affected banks, which have been able to build internal expertise to monitor projects and release rapid decisions.

During the crises with the collapse of monolines¹⁹ and the credit crunch issues, long-term liquidity was not available. The impact of Basil III on infrastructure loan maturity has been remarkable: from 2006-2008 average maturity was approximately 15 years, it decreased to 6 years in 2011; afterwards it started to grow slowly, however currently it is still below 10 years²⁰. Furthermore, the crises highlighted the crucial aspect that 70% of global infrastructure financing have been dominated by banks (15% by equity, 8% by bond and by 7% Government or Development Banks)²¹. In Europe the situation is even more remarkable with the share of debt estimated at about 85%. In particular, the European project finance debt market has been dominated by banks which represented 90% of debt funding, with only 10% coming from other instruments (i.e. project bonds).²²

After the crises, without monolines, with banks facing significant difficulties offering long tenor debt and in the overall uncertain atmosphere, the EU and a number of governmental institutions began to offer guarantees/credit enhancement structures/first loss mechanisms in order to trigger traction and channel the private investment towards infrastructure. One of the most well-known of these structures was the Project Bond Credit Enhancement "PBCE" (set up within the Project Bond Initiative) offered by the EIB, but there were many others examples.

The UK Guarantee, the PEBBLE (Pan European Bank to Bond market Loan Equitisation), the Cession de Créance in France are examples of the efforts (especially in the transport

18 Review of European PPP Market – EPEC – February 2015.

19 The only monoline that continued to operate was Assured Guarantee.

20 B20 Infrastructure and Investment Task Force – March 2015.

21 Building Growth in Europe – Innovative Financing for Infrastructure – Chatham House Report – September 2014.

22 Building Growth in Europe – Innovative Financing for Infrastructure – Chatham House Report – September 2014.

sector) that some of the Member States made to respond to the new difficult situation and try to revamp investments. Despite the lack of success of some of these structures, some others were used to efficiently reach financial close and they still remain quite useful to attract private finance and sustain economy. However there is still a long way to go.

Examples of Government Guarantees/Credit Enhancement instruments in the EU

The UK Guarantees Scheme. It is a Government scheme, approved in 2012, designed to kickstart crucial infrastructure projects. The Government made available a total of GBP 40 bln in order provide financial support for a wide range of infrastructure projects (*inter alia utilities*, railways, road, health, education), The support takes the form of an unconditional and irrevocable guarantee of scheduled principal and interest in favor of a lender to a UK infrastructure project (Beneficiary) and on behalf of the relevant borrower/issuer of debt (the Company). The UK Guarantee is issued in return for the payment of a guarantee fee to be charged at market rates. Under current plans the scheme is due to end in December 2016 as market lending conditions have improved. Eligible projects for the guarantee will have to be nationally significant; ready to begin construction in the next twelve months; financially credible; not otherwise financeable; and good value for money.

PEBBLE (Pan European Bank to Bond market Loan Equitisation), was announced in December 2012 by Allen & Overy, along with ING, (and subsequently been adopted by the International Project Finance Association) as a form a funding format for greenfield projects financing. It is a construction revolving facility provided by commercial banks and periodically refinanced by a combination of the A Notes and B Loan. A Notes which are subscribed by institutional investors and rank senior to the B Loan; and the B Loan provided by commercial banks, which ranks junior to the A Notes, but is scheduled to amortise in advance of the A Note principal repayments. The A Notes and the B Loan will be drawn in a ratio of 85:15. Prior to the B Loan being amortised by 35 per cent, the B Lenders will act as controlling creditor. After this, the A Noteholders and B Lenders will together be controlling creditor.

Cession De Créance – France The “Cessions de Créance” is regulated under the framework on the Law “Dailly” (1981) and has been used for the financing of many French PPPs. The public authority granting the PPP contract (which has the obligation to pay a service charge to the PPP company over the life of the contract) agrees in advance to accept that a percentage of those payments (receivables) will be transferred to the lenders, under certain conditions. The main conditions under which this acceptance becomes valid are that (i) construction must be completed and the project in operation and (ii) only a percentage (maximum 80%) of the part of the service charge corresponding to the investment and financing costs can be transferred. After acceptance by the public authority, the benefit of the transfer becomes irrevocable, irrespective of whether the services under the PPP contract are being rendered or not. The rationale behind this structure is that the financing backed with this assignment of receivable will be considered as public borrowing by the lenders and therefore should imply low interest payments.

Current situation and bottlenecks. What's next?

As mentioned above, although liquidity seems to be back in the market, the underinvestment problem is still affecting Europe. There are many issues that needs to be overcome for the economy to fully recover.

The EU Task Force study outlined that the Member States perceive as main barriers for long-term investment three main issues: financing constrains in terms of public and private sources of financing, regulatory framework and project complexity.

More than 75% of the Member States pointed out to financing constraints as a barrier to long-term investment. Government budgets are highly constrained in many Member States which has led to a remarkable decline in Governments investment, either directly in public sector projects, or more indirectly through projects sponsored by the private sector (concessions; Public-Private Partnerships (PPPs)).

The second barrier mentioned is the regulatory framework. As we all know, a stable, coherent and trusted legal framework is a pillar for private investment involvement. In particular, the fragmentation of the internal market is considered a major impediment to investment. An enabling framework, establishing an effective integrated market for energy and infrastructure network is a prerequisite for Europe's return to sustainable growth. At this regard, political risk is also among the greatest concerns of private investors. Sudden cuts in the tariffs, new regulations, or just new "Government trends" against private involvement in infrastructure can remarkably affect the private sector willingness to invest. For instance, recently the French Government decided to freeze the tolls charged by the country's private operators (fortunately an agreement was reached later on), in Germany there have been a number of "remunicipalizations" and even in UK, which has been a pioneer country in private investment for infrastructure, in December 2002 the PFI program has been replaced by the smaller scale program PF2.

It also important to remind that Europe has suffered from regulations and accounting standards unfriendly to long-term investments (IAS/IFRS, CDR IV and Solvency II, Omnibus) which have penalized the financing of the real economy. The Basel Committee is debating a new set of rules (Basel IV) which would make even harder to finance investment and the real economy. The risk is that EIB and NPBs are left alone in a market where other potential investors will have no convenience to participate (even if they wished to do so) due to rules drafted with no clear understanding that economic growth (that is, long-term investment) is a binding condition for both financial stability and long-term sustainable fiscal consolidation²³.

Complex project structuring and preparation has been also identified as another challenging barrier. This is actually a serious issue especially for PPPs/Project Finance transactions because they require a complicated contracts structure to be implemented that can be difficult to achieve when the counterparts of the projects are not familiar with these schemes (i.e. institutional investors, public administration).

The administrative burden is another bottleneck that is still affecting project developments. In many countries, not only timing for approvals is a crucial issue (during

23 Evitare il fallimento del Piano Juncker – Franco Bassanini, Edoardo Reviglio – Aprile 2014.

execution), but also the fragmentation of planning among different levels of government is delaying “projects conceptions” from the inception. According to the Commission estimates, a 10% reduction in administrative burdens can over time increase investments by 0.6 % and GDP by 0.8 %.

Additional difficulties which are also common for infrastructure financing are lack of standardization of project structures (procurement procedures, concession contracts etc) and inadequacy of administrative/ project management capacity from the public administration. Further efforts should be made at national and at EU level to promote standardization among procuring authorities. Transparency and access to high-quality data on projects is crucial to enable investors to assess risks related to a project.

Technical deficiencies in terms of traffic forecast and costs overruns are often crucial challenges too: it has been estimated that on average 84% of rail projects and 50% of road projects have traffic forecast overestimated by 20%, while cost overruns are in the range of 45% for rails and 20% for roads²⁴

On top on these problems, it has to be reminded that banks still retain the lion’s share of infrastructure financing.

Europe has been facing all these issues that are slowing its growth; today there are signs of recovery, however the market seems to face also a new challenge. There is a paradox in the market: liquidity is available, but banks, sponsors, institutional investors and equity funds continue to be very caution in bearing risks and, most of all, seem to face difficulties in finding viable projects. The problem is matching the supply with investible projects

For certain countries, the lack of a stable, credible and transparent pipeline of sound projects is certainly one of the main reasons for underinvestment problem. This is problem is affecting not only Europe: it is interesting to mention that only 50% of the G20 countries published a clear pipeline of infrastructures projects²⁵. Therefore it is of essence for Governments to draft a National infrastructure long-term investment plan and a transparent project pipeline, rather than proceeding with urgent decision-making on individual projects. The investment plan should identify the sectors or economic activities whose investment is critical for long-term growth and the projects which incontrovertibly require grants (projects that have capped tariffs which prevent revenues to reimburse debt and to remunerate capital) or any forms of public intervention. This would help to avoid inefficiency and waste of public financial resources.

Both the investment plan and the pipeline of individual projects should be communicated transparently in order to help the private sector to identify attractive investments. There should be a clear criteria for including projects in the pipeline: clearly their economic viability should be a key issue.

Currently regarding existence of national infrastructure investment plans, there is fragmentation among the Member States. While the majority of the Member States have long-term investment plans and sectorial strategies, only few, including the UK

24 B20 Infrastructure and Investment Task Force – March 2015.

25 B20 Infrastructure and Investment Task Force – March 2015.

and the Netherlands, have managed to aggregate their needs into a comprehensive national infrastructure investment plan with transparent project pipelines.

Another main reason for persistently weak investment is uncertainty and low expectations about the demand. This climate, together with a fragmentation of financial markets, brings to a low investors' confidence and a lack of sufficient risk-bearing capacity that is required to catalyze investments.

This situation, affects the transformation of savings into productive capital and it is delaying a full recovery in Europe.

Since private finance is not reaching the real economy and Governments are facing fiscal constraints, public money, funds from international institutions and NPBs, should be probably used to strengthen the risk-bearing capacity (through credit enhancement/guarantees) of private investors by creating new instruments (or sharpening the existing structures) which can trigger high multiplier effects. This approach would help to re-launch private investment and enable projects that would otherwise considered too high risk.

For instance, the Loan Guarantee Instrument (LGTT) for the TEN-T, has been actually technically efficient, however it has been implemented only in few projects. To overcome the limited implementation, the maximum level of the guarantee could be increased and/or the risk coverage could be extended beyond traffic risks and/or the cost of the instrument could be reduced or deferred throughout the duration of the warranty.

Currently investment in transport infrastructure is still mainly funded with public money which often also covers approximately 50% of operating costs of public transport services therefore it is critical for Governments to shift more and more from a taxpayer to user pay scheme and minimize the amount of grants by offering structures that can reduce private investors risks.

In order to increase the leverage, grants from the EU budget should be combined with private financing schemes, which can benefit themselves from EU financial instruments. Grants from the European Structural and Investment Funds ("ESIF") could be combined with financial instruments from the CEF and blended with National Promotional Banks ("NPBs") financings.

A great effort is needed to attract more and more private finance also through Project Finance/PPP structures, and match the supply of finance with investible projects. Globally only 10% of infrastructure investments are funded with Project Finance schemes, while the biggest share (54%) is financed by public money and the remaining (36%) through corporate financing²⁶. Since 2012 the PPP market is growing again: a 15% increase in value (aggregate value in 2014 € 18.7 bln) and 2.5% in numbers of deals closed was recorded over 2013²⁷. However there is room for remarkable improvement especially regarding the risk sharing issue between the public and private sector. PPPs could play a relevant role in the delivery of TENs projects in transport and energy.

26 B2o Infrastructure and Investment Task Force – March 2015.

27 Market Update- Review of the European PPP Market in 2014 – February 2012.

In order to reduce Europe bank lending dependency, it is time to fully support the involvement of new actors in order to foster equity investments or other forms of debt. The institutional investors (as equity sponsors or lenders) could play an important role to address the EU's infrastructure gap. This is a well-known issue, however the following estimates can give a concrete idea of the magnitude of the potential of this source of funding.

In Europe insurance and pension company hold around € 12 trillion of assets which means 90% of EU GDP²⁸. A Linklaters²⁹ research showed that global institutional investors have funds of US\$1trillion at their disposal for potential investments in European infrastructure assets over the next 10 years.

A growing interest from institutional investors to participate in the infrastructure market as senior lenders (Castor) or equity sponsors (Ardian Tunels de Barcelona, Blacstone acquiring Metro de Malaga) has been actually recorded. This is a good sign, meaning that infrastructure is becoming an asset class and that institutional investors seems to be interested in this new type of investments with peculiar risk profile.

EPEC has estimated that in 2014, 28% of the PPP transactions³⁰ (i.e. 23 transactions; 16 in 2013) involved the provision of debt by institutional investors through a variety of financing models. Overall, institutional investors lent around EUR 2.8 billion (EUR 2.5 billion in 2013) to European PPPs at very long maturities (on average 24 years, with a maximum of 43 years). Six countries closed transactions involving institutional investors' debt: UK, Belgium, Denmark, Germany, Ireland and the Netherlands (compared to only three countries in 2013).

In order to encourage the involvement of institutional investors in infrastructure projects, it is crucial to set up teams of experts like Allianz and M&G, who have built up deal teams with as much expertise as the project finance banks.

Furthermore to overcome the bondholder decision making problem, a number of structural and institutional have been implemented in some recent projects. Quick responses, for example, has been reached through various innovations regarding the role of a "Majority Bondholder Representative", or for the first time in AWPR Project³¹, (Scotland, UK) with a "Super-Majority Bondholder Representative".³² These kind arrangements could be implemented in other projects.

Due to Basel III, bank long tenors are difficult to obtain and/or they will be expensive. However, co funding structures between banks and bondholders could therefore

28 Buiding Growth in Europe – Chatham House Report – September 2014.

29 Set to revive- Investing in Europe's infrastructure – Linklaters – 2014.

30 EPEC – Market Update Review of the European PPP Market in 2014 (the estimate in referring to all sectors).

31 Aberdeen Western Peripheral Route Balmedie to Tippetty (AWPR / B-T) involves the construction of 58 kilometres of new dual carriageway to bypass the city of Aberdeen in eastern Scotland. The project also include 40 km of new side roads, 30 km of access tracks and two bridges.

32 This is an elected bondholder representative which, subject to certain restrictions, is able to vote the exposure of the bonds on decisions up to and including calling events of default.

accommodate the needs of institutional investors, who are often focused on finding long-term returns to match their liabilities, and banks which are facing tenor issues.

These co-funding structures are actually emerging: in AWPR project, the banks and the institutional investors co-invested as senior lenders, with the bank debt amortizing ahead of the institutional debt.

Therefore, not only it is of essence to broad the potential group of investors and the mix of financial instruments, but different financing instruments should be used for different phases in order to reach the optimal structures where risk and return profile best suit the public sector and the various type of investors.

Europe bank lending strong dependency is dangerous for the obvious reasons, but also because bank lending is usually highly pro-cyclical, growing significantly during booms and contracting during crises, therefore it amplifies the effects of a business cycle. This doesn't mean that the banks should have a marginal share in the market. Banks play an important role in the market by providing technical skills and supervision but, first of all, they act as catalyzer in bringing non-banking long-term finance to infrastructure. Hence governments should take action to remove regulatory disincentives to long-term bank financing to ensure continued participation of banking especially as a mean for attracting additional types of investors.

The Capital Market has room for great expansion and the union of the market should be one important goal to reach. Capital Market Union ("CMU") is certainly a EU priority and the Green Paper published in February 2015 is certainly a sign that there is a great focus on putting in place the building blocks for a CMU by 2019. Bonds not only have longer maturity, but the broadening of this market will also help the European Central Bank ("ECB") to have instruments through which it can develop its monetary policy. In United States approximately 45% of NF corporations are financed by bonds, while in Western Europe, bonds represent only 21%³³. Action should be taken in many areas in order to developed a more integrated capital market. Increase tax incentives for institutional investors investing in long-term infrastructure projects, encourage greater diversification towards alternative instruments such as private equity and venture capital, developing a private placement market both for debt and equity instruments, are just few of the measures that could be envisaged.

The rebuilding of the European market for securitization can also help to foster long-term growth and it can represent a large class for ECB monetary policies³⁴.

Infrastructure funds carry a high potential too, since they usually seek long-term investments. At European, national and NPBs level, efforts should be made to maximize this potential: for public/international funds it is crucial to avoid too restrictive investment strategies because they can reduce the pipeline of eligible projects and therefore their use could be limited.

33 McKinsey Global Institute Financial Stock Database, 2012 McKinsey Global Institute Analysis.

34 Quantitative Easing, structured finance, and support to real economy. Proposal on ABS – Astrid – Basanini et al. – November 2014.

Blending funding means (i.e. combining private financing with grants or credit enhancement structures from European and national sources) would help to extend the use of PPPs also and could support PPPs to have more cost-efficient structures.

Finally the Juncker, through the EFSI,³⁵ should roll out credit enhancement on a pan European scale unlocking additional investments of at least € 315 over the next three years by taking on some of the risk and mobilizing private investment.

EFSI will fund sound projects, on sectors of key importance, where needed and where it will bring added value and increase risk profile (if necessary). It is of fundamental importance to ensure additionality addressing market failures without crowding out private source of capital. At this regard in order to make the Juncker Plan really effective, it is quite essential to offer guarantees below market prices in order to stimulate additional investment by making eligible projects which would not had been bankable at market standard alone³⁶.

EFSI aim is to fill the market gap by increasing promoters' appetite, by attracting funding from private investors and transforming the liquidity into investments.

The Juncker Plan is actually the most remarkable economic policy measure taken at European level in the last years. However its success will depend on the implementation on national and European reforms which will set the right framework for attracting private investments including stable legal framework, liberalizations, rapid administrative procedures, and all the reforms that we all know to be necessary but that, for some reason, they are still waiting to be implemented.

It is crucial that Member States and NPBs will also support this strategy and supply the pillars for this plan in order to be effective.

In April 2014, the announcement for the contribution from Italy, Germany, France and Spain through their NPBs³⁷ to regional platforms and projects which will be selected by the Juncker Plan, is an important signal that these Member States are willing to take a strong active role in the Juncker Plan and in getting Europe investing again and ensure the best use of resources.

The Plan actually envisages that the NPBs can play a crucial role for the most effective use of available public funds and in supporting private investments.

NPBs are willing to further enhance their cooperation with the European Invest Bank ("EIB") and they are ready to expand their activities with the complementary support of the increased EIB risk capacity (part covered by EFSI) in many areas such as ABS transactions, Global Loans, Venture Capital, Funds of Funds, Project Finance/ PPPs, acting as investor or anchor investors, improving access to loans offering technical assistance or increasing commitments in European funds and widening their investment policy (i.e. Marguerite).

35 European Fund for Strategic Investments.

36 Evitare il fallimento del Piano Juncker – Franco Bassanini and Edoardo Reviglio – April 2015.

37 CDP € 8 bln, KfW € 8 bln, ICO € 1.5 bln, CDC and BPI € 8 bln.

Italian commitment on European Networks – Highlights

Working on European integration is a main goal for Italy.

The Italian Economic and Infrastructure Plan 2015 has a remarkable focus on the completion of the European networks and many related projects have been included in the priority list.

In particular regarding TEN-T, in March 2015 Italy (which has 4 multimodal corridors crossing its country) has submitted to the Commission 83 project proposals to be completed within 2020. The aggregate value of the overall projects is € 7 bln. For these projects Italy has requested 2.5 bln (21% of the available budget) under the CEF first call. In line with EU principles, 85% of the fund requested are referring to rail projects. With reference to the energy sector, the strategic plans 2015-2019, just announced by Terna and Snam, confirm Italy's commitment in supporting European integration.

Snam 2015-2018 Strategic Plan shows total investment of € 5.1 bln to increase flexibility of the gas system and enhance interconnection with European networks. The company plays a significant role in the integration of European gas infrastructure thanks to targeted investments and partnerships along the two main continental energy routes, South-North and East-West. TIGF (Transport et Infrastructures Gaz France) strategically located along the connection route with the Iberian peninsula, will help to increase the integration of the French market and new possible international interconnections. The TAG pipeline, which is the most important gas import infrastructure for the domestic market, is a strategic asset for the integration of a European common market, also considering its potential use in reverse flow towards Eastern Europe and Southern Germany.

Terna Strategic Plan 2015-2019 has allocated € 3.9 bln (compared to 3.6 bln of the previous plan) for the development of the electricity grid. The company will be very active in the construction of the new cross border interconnections which will bring a greater energy independency for Europe. On-going interconnections work such as "Piosasco-Grand'Île", between Italy and France, and "Villanova-Tivat", between Italy and Montenegro are examples of Terna's commitment in European integration.

The EU Funds for Energy and Transport: Marguerite and EEEF

The Commission and the EIB are concentrating their efforts in stimulating private capital towards infrastructure even through the creation of funds with the aim to trigger a catalytic effect.

Selected investments are highly focused on EU priority objectives: infrastructure, environment, energy efficiency, renewable etc and are aiming to reach, most of all, added value, additionality and multiplier effect.

Equity funds constitute the majority of infrastructure funds, while debt infrastructure funds represent just a small percentage. That said, the interest in debt has been rising after the financial crisis with focus on Europe.

Europe remains the most significant region for the infrastructure asset class globally. The following figures on equity funds confirm this potential role: 58 Europe-focused infrastructure funds in the market; 133 number of deals developed by unlisted funds in infrastructure assets in 2013; 53% of the transactions have taken place in the past five years involving European infrastructure assets; 52% of Europe-focused infrastructure funds are at or above their target allocation to the asset class and the average size of European infrastructure deals in 2013 was € 395 mln.

It has been evident that most of the funds focus on investment with a lower risk-profile which means advanced brownfield or secondary stage infrastructure assets, while 80% of the current pipeline available globally to private equity investors consists of greenfield projects.

Analyzing the features, the investment strategies and the performance of the funds available in the market is extremely important for the EU and NPBs in order to analyze which financing gaps still need to be addressed and which kind of vehicles are still missing in the market.

A brief description of the two funds (inter alia) which support European goals and whose mission is to address specific market failures, has been outlined below:

Marguerite

Marguerite is an equity (or quasi-equity) fund set up in December 2009 by Cassa Depositi e Prestiti (CDP), the European Investment Bank (EIB), Kreditanstalt für Wiederaufbau (KfW), Instituto Crédito Oficial (ICO) and PKO Bank Polski (PKO). Each of the core sponsors backs Marguerite by a contribution of EUR 100 million.

Three further investors have committed an incremental €110 million to the Fund (the European Commission – EUR 80 million, Caixa Geral de Depositos – EUR 20 million, and Bank of Valletta – EUR 10 million), bringing current commitments to €710 million.

The fund acts as a catalyst for investment in infrastructure projects which develop European networks, which counter climate change, enhance energy security and invest in mature renewable. It has a particular focus on greenfield transactions and TEN-T and TEN-E priority projects, developed through a project finance structure, with the aim of complementing other private resources, therefore without crowding out private investors.

Marguerite has a focus on projects whose total expenditure is greater than € 200 mln, and € 50 mln for renewable energy. The minimum investment in a project should be € 10 million. The fund takes minority participation. For portfolio diversification issues, currently no more than 10% of the Fund's Target Total Commitments should be invested in any single deal.

Any investment representing more than 5% of the Fund's Target Total Commitments is subject to a right of veto of the Board. No more than 60% of the Total Commitments should be concentrated in any one of the core sectors.

The Fund invests in EU countries with particular regards to the needs of new EU Member States.

So far Marguerite has screened many investment opportunities. But the majority of the projects have been considered not viable (because they missing the pillar conditions for a long-term investment) or have been judged in an immature stage. Out of the ones selected, less than 50% were submitted for final approval.

So far 10 projects have been closed (7 in renewable energy and 3 in the transport sector).

Energy Efficiency Fund

The European Energy Efficiency Fund (“EEEF”) aims to support the goals of the European Union to promote a sustainable energy market and climate protection.

EEEF is a public limited liability company qualifying as an investment company with variable share capital – specialized investment fund.

The Fund was initiated by the European Commission in cooperation with the EIB. The initial capitalization was provided by the European Commission it was increased mainly with contributions from EIB, CDP and the Investment manager Deutsche Bank. The fund is open to investments from institutional investors, professional investors donor agencies, governments, international financial institutions, and professional private investors. There are three different categories of shares for investors:

- C-Shares bear the highest risk (“First Loss”) and serve as a risk buffer for the more senior share categories (Subscribed by the European Commission). B-Shares rank senior to C-Shares and are remunerated on a 6m Euribor + Spread basis..(Subscribed by CDP, Deutsche Bank and EIB).
- A-Shares rank senior to B-Shares and are also remunerated on a 6m Euribor + Spread basis, however at a lower level than B-Shares to allow for risk/return adjustments. (Subscribed by CDP and EIB). In addition, notes may be issued in the future. They rank senior to shareholders, but junior to all other creditors of the Fund.

The Fund focuses on financing, in the EU, energy efficiency, small-scale renewable energy, and clean urban transport projects (at market rates) targeting municipal, local and regional authorities, and public and private entities acting on behalf of those authorities (i.e. ESCOs)

To reach its final beneficiaries, EEEF can use two types of investments: direct investment and investments into financial institutions (local commercial banks, leasing companies etc).

Investments instruments include not only equity, but mezzanine, senior debt, leasing and forfaiting structures. guarantees. Debt investment can have a maturity of up to 15 years while equity can be adapted to the needs of the project. Equity in-

vestment is not permitted in financial institutions. The Fund provides market-based financing.

Conclusion

Creating an integrated trans-European system is vital for EU competitiveness and territorial cohesion. The Member States must continue to work in order to overcome all the institutional and regulatory barriers which have been affecting Europe since a long time and, at the same time, face the new market challenges emerged after the economic crises. To achieve these goals Europe needs a long-term vision.

Frozen capital must be mobilized and put into productive use. There is an urgent need for a stable pipeline of priority projects in order to provide long-term visibility for both public and private actors. Where the risk profile of these projects result unattractive, it is of essence to set up new financial instruments or elaborate sophisticated structures which can address these issues.

It is crucial to develop infrastructure as a strong, viable asset class in order to offer more investment opportunities and attract a broader range of investors

In a period of lack of Governments' resources, the best use of public and EU funds is for innovative solutions which can trigger high multiplier effects; this will allow grants to be saved for those projects that are not financially viable (due to the nature of their business). In this effort it is of paramount importance not to crowd out private investors as there have been examples of standing alone projects just utilizing innovative financings.

In order to foster growth it is of essence to re-establish private investors' confidence. At this regard, the EU and the NPBs must continue to play the catalysts role for private investments in the new market situation.. They need to act as a market maker by leveraging the funds available and offering the appropriate tools which can shape investment opportunities with risk-adjusted profiles and structures precisely tailored for current market investors' type of appetite.

Banks should continue to play an important role, although it is essential to reduce or blend market dependency to the bank system. The capital market should be further developed; bonds could be also considered for clusters of projects in order to diversified risk and enhance credit worthiness. This could be envisaged for interdependent projects as, for instance, those located along a core network corridor (Corridor Bonds).

The securitization of loans could represents a bridge between banking and market funding and can integrate other long-term funding sources revamping the market.

In the meanwhile, it seems that institutional investors are starting to be more interested in infrastructure investments and are also becoming accustomed to the status of "active decision makers". Regulatory disincentives to long-term infrastructure financing should be quickly removed in order to capitalize on this huge potential.

Unstable political environment (reflecting into pricing, legal framework, etc) is still a significant barrier as investors look for a stable framework which allow them to assess risk throughout the long lifespan of an infrastructure investment. Action should be taken at this regard too.

The future of Europe will depend on our capability to work together in harmonization. It is imperative to stop procrastinating the implementation of the essential reforms and proceed with a strategic use of resources available through structures which can “package” infrastructure investments which precisely suit current market risk bearing profile.

It is now time to “roll at full speed and take off”.

PART III

THE UNEXPLORED BUSINESS WITHIN SOCIAL INFRASTRUCTURE

An overview

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David Wood, Lorenzo Scione*

Globally, there is renewed interest in and understanding of the value of social infrastructure¹ in our economies. But in North America, the Far East, Australia and New Zealand these investments are also seen as more than catalysts for new business opportunities that enhance economies and internal markets. Social infrastructure brings other benefits that are essential for economic performance and human development: attractiveness of place, employment, improvements in social and human capital, a better quality of life and critically, services for currently unmet social needs. In these countries, investors are allocating up to 10% of their overall assets to social infrastructure compared to around only 1% in the EU (OECD 2012).

While the quantity and quality of infrastructure (including social infrastructure) investments is growing globally, infrastructure gaps that can act as a brake on growth² remain a challenge in the EU. The prevailing infrastructure lag in the EU is partly a result of the decline in public spending. But it is also due to a lack of strategic long-term planning, poor concept development and inappropriate financing options. This is a fundamental flaw in the policy mindset.

While access to transport airports, ports, road networks and, in some cases, railroads, is the minimum common denominator for economic clusters to grow and thrive, what makes a real difference is the breadth and depth of the social infrastructure provided in the cluster. Particularly in developed markets, offering differentiated children's day care, clinics, banks, and other basic necessities will influence the decision of a company to set-up or relocate to a specific cluster. The logic of social infrastructure as a catalyst for growth in economic clusters also applies to the need for attractive, cohesive and vibrant communities.

In this context, the key to developing investable social infrastructure is the ability to know when private investment is the path to go down, and right now we don't have the

- 1 Social infrastructure is a sub-sector of infrastructure (in place assets and network assets) that consists of the social connections and the organisations and services that build them in a community. Strong social infrastructures create strong communities with resilience and the foundations for growth in both economic capital and social justice.
- 2 Inderst G. and Stewart F. (2014), Institutional investment in infrastructure in developing countries: introduction to potential models. The World Bank, Policy Research Working Paper 6780, February 2014.

best ways to sort that out with the public interest in mind. This first chapter in Part 4 briefly covers some of the issues we need to address in order to find answers to realising the full value of social infrastructure for investors and local communities. The following chapters then give more detailed consideration to key issues from the demand, supply and institutional sides.

Convergence between the economic value of 'hard' and 'soft' infrastructure

The term “infrastructure” does not have a unique definition, but it can be generally defined as the set of interconnected structural elements that provide a framework supporting an entire structure of development. As the New Zealand Social Infrastructure Fund proposes, infrastructure can also be defined as long-term physical assets.

There are two types of social infrastructure assets: in-place infrastructure (also called fixed infrastructure) such as: civic and leisure, culture, education including pre-school, health and social care, social housing, urban green space; network infrastructure including ambient living, green energy, ICT, transport connections, waste management and water systems³.

Guides to infrastructure investment⁴ tend to show that network infrastructure types such as energy, ICT, transport connections, waste and water are core economic infrastructure. The premise is that these are assets whose financing and operation involve private parties and that provide an investment stream paid (or in principle payable) by users.

In contrast, social infrastructure assets were usually financed, owned and operated solely by public authorities. They operate in markets with high barriers to entry but they also enable the provision of goods and services. However, social infrastructure is not just ‘bricks and mortar’.

It comprises the totality of services and facilities provided to meet the needs of communities, provide direct and indirect employment, promote social interaction and enhance the quality of life of their members. In summary, it includes material assets, social and human capital.

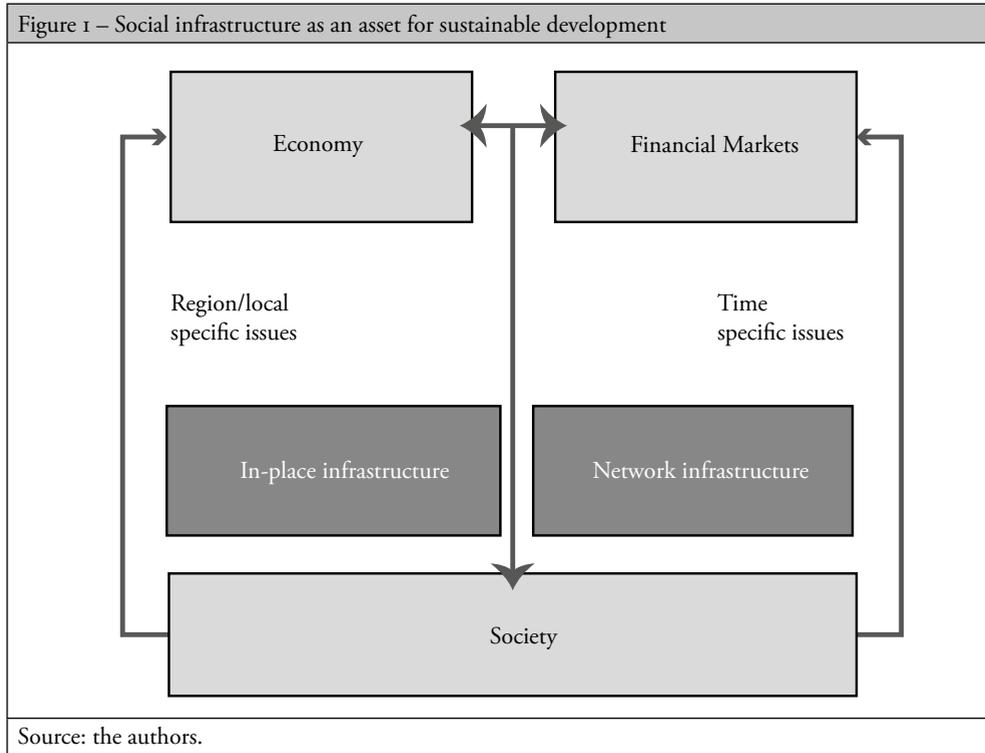
As Figure 1 shows, social infrastructure is an essential foundation for sustainable economies, financial markets and communities as evinced by the dependency of each element and the feedback loops. In today’s economy where enhancing the value of social and human capital is a key concern, infrastructure investment decisions affect how municipalities, cities and regions function.

Overall, there seems to be a blurring of boundaries between social and economic infrastructure. This reflects: their interdependencies and multiple impacts; governments withdrawing further from their provider responsibilities; questions about what needs to be provided by public finance directly to support people on low or very low incomes

3 For more information go to: <http://www.nzsif.co.nz/>.

4 For example – Afzi Working Group and JP Morgan Asset Management (2013) Guide to infrastructure investing – for use by institutional investors. [http://www.jpmorganassetmanagement.ch/DE/dms/Guide_to_infrastructure_investing_\[MKR\]_\[CH_EN\].pdf](http://www.jpmorganassetmanagement.ch/DE/dms/Guide_to_infrastructure_investing_[MKR]_[CH_EN].pdf).

and, actually to ensure services to those of the working middle class who can no longer afford market prices.



Fighting fires makes the infrastructure gap worse

Since adoption of the Europe 2020 Strategy, EU priorities (and those of member states) have been to address growth and fiscal conditions⁵⁻⁶. These issues have had a significant and ongoing effect on finances for public services at all levels. Local government revenues have declined in real terms in many European countries that provided data for 2009-2010, for example by 19.7% in Bulgaria, 13.1% in Germany and 11.3% in Ireland⁷.

More recent figures for 2011 show that: sub-national revenue (excluding borrowing was stable) [+0.2% in volume terms]; subnational expenditure (excluding redemption of the debt in capital) was slightly down [-0.2% in volume]; subnational direct

5 European Commission (2012). Annual Growth Survey 2013. COM 750 Final.

6 European Anti-Poverty Network (2011) Is the European project moving backwards? The social impact of the crisis and of the recovery policies in 2010. EAPN Brussels: 36.

7 Davey K (Ed.) (2012) Local government in critical times: Policies for Crisis, Recovery and a Sustainable Future, Council of Europe texts 2011, Strasbourg, February.

investment was down by 6.6% following a 7% drop in 2010⁸. It seems that authorities have protected current expenditure on existing services at the cost of capital accumulation. This is critical as regional and local authorities are directly in the front line on issues that affect economic performance, such as business closures, unemployment and social problems.

The infrastructure gap in the EU has exacerbated the problem of structural lag. Structural lag is a condition that occurs when two related structural characteristics of a social system change at different rates and therefore become out of sync with each other. In the EU structural lag is the break between changes in society reflecting ageing populations and subsequent structural reforms (ranging from employment to care), the response of societal institutions in providing appropriate social infrastructure and the attitudes and values that underpin key decisions. Structural reforms may have short-term impacts and longer-term benefits⁹ but their overall purpose is to reduce the sustainability gap in public finances¹⁰.

This situation is compounded by problems on the institutional and demand-sides that prioritise actions to alleviate symptoms (fight fires) rather than strategically address a need or problem to deliver transformative change:

- On the institutional side – Key decision-makers and their advisers can sometimes be tempted by “quick fixes” when under pressure. Flawed academic/expert work is used without critical appraisal to support decisions¹¹. Policy makers sit hoping that something will happen that they can then cling to and claim the benefits of. This is lazy decision-making based on poor assumptions: that supply creates its own demand; that tighter fiscal rules and austerity reassure financial markets and stabilize the public sector and; that the social consequences of austerity-driven governance is acceptable.
- On the demand side – The key problem is that despite rhetoric, the demand-side is fixated with short-termism. This is largely driven by political resistance to thinking and acting strategically combined with the financial pressure on public services to continue fighting fires instead of looking ahead. Few regions or public/social sectors in the EU undertake long-term planning and associated risk assessment. Those that do include Kymenlaakso [Finland], Norbotten [Sweden] and perhaps Berlin-Brandenburg [Germany]).

8 CCRE/CEMR (2012). Further decline in European subnational investments in 2011. Council of European Municipalities and Regions/Dexia Crédit Local. Press Release, Brussels and Paris, 18 September.

9 OECD (2013) The short-term effects of structural reforms: An Empirical Analysis, OECD Economics Department Working Paper s No. 949.

10 European Commission, (2009) Sustainability Report 2009. European Economy 9, DG ECFIN. EC: Luxembourg.

11 Legrain P. (2014) European Spring: Why our economies and politics are in a mess.

Tools and competencies needed to deliver sustainable social infrastructure

The infrastructure backlog (in its various forms) is due to lack of strategic long-term planning, associated long-term risk assessment, poor concept development and inappropriate financing options. These in turn have led to: structures and services not being sufficiently flexible, interchangeable and open; sunk costs; path dependence; political capture and rent seeking. As exemplified in cases from the USA and Australia (and as emphasised in an INTEGRATE contribution to the consultation on the EC Green Paper on Longer-Term Funding), long-term planning and associated long-term risk assessment/project appraisal are necessary foundations for securing long-term investing in social infrastructure.

Social infrastructure needs to be innovative in order to overcome structural lag and attract investment. Accordingly, long-term investment in social infrastructure – using the principle of “patient and productive capital” – should be informed by innovative concepts to develop and safeguard social infrastructure provision that take account of demographic change, new knowledge, and shifts in societal preferences – and which are practicable under difficult financial conditions¹². This is essential to generate and maximise sustainable and attractive cash flow for institutional and other investors.

Longer-term investing in the EU needs better collaboration

The Regulation for European Long-Term Investment Funds that that will formally come into being in the next few months is discussed in detail in later chapters. It is a solid starting point for investors because it will be ready to operate (or perhaps experimented with). However, they remain to be convinced that the ‘demand side’ is ready to absorb significant investment.

There is now momentum for long-term investment in social infrastructure by institutional investors. But to be realised supply, demand and institutional-side stakeholders need to work together to find complementary and innovative solutions. Money is available for long-term investment but the demand-side (regional and city authorities, public and social sectors) voice is largely missing in policy dialogue, shaping investment products and providing long-term platforms for investment. In particular, there is a need to

- Strengthen both institutional and demand sides by incentivising a break from short-termism in risk assessment, planning and decision-making.
- Blend financial, social and environmental innovation in order to create transparent hybrid capital strategies that allow cost effective and sustainable implementation of the action plan for long-term financing of the European economy.

12 Winkel R (2008) Innovative concepts for social infrastructure. German Journal of Urban Studies 47(2). www.difu.de/node/6832.

- Provide a route for generating pipelines of investable long-term projects that will deliver a sustainable return on investment combining cash flow and public value¹³.

Addressing these challenges and opportunities should be shaped by a set of core strategic principles: full coverage and innovative infrastructure.

Achieving shared value from Long-Term investment

As well as financial returns, social infrastructure brings other benefits that are essential for economic performance. These include attractiveness of place, employment, improving social and human capital, a better quality of life and critically, services for currently unmet social needs. Two of these goals reflect EU and national priorities: climate change targets and employment as an economic priority”

- The climate change targets and associated commitments of EU member states and regions also tie social infrastructure planning and investment to: necessary shift from high energy to low carbon infrastructure¹⁴. And this shift needs to be incentivized. As a new report states: A shift to low-carbon infrastructure will have an additional impact, changing both the timing and mix of infrastructure investment¹⁵⁻¹⁶.
- The 2014 Annual Growth Strategy¹⁷ set out EU economic priorities for the coming year. These focus on sustaining recovery with “investment and employment” as the new mantra. Improving the resilience of labour markets and boosting job creation in fast growing sectors are the key employment priorities.

However, achieving shared value is not as simple as its practitioners and advocates claim. For its potential to be realised to the benefit of local communities, businesses and organisations pursuing shared value need to ensure that their human resource policies prioritise inclusiveness and that this is reflected along their value chains. Specifically, that reducing youth unemployment, inclusive employment policies and/or extending attractive working lives along the value chain are included as social impact criteria in fundable projects.

13 Inderst and Stewart (2014).

14 For an example of how sustainable infrastructure needs to also address climate change issues both for in place and network infrastructure see: Dale A and Hamilton J (2007), Sustainable Infrastructure: Implications for Canada’s Future. Infrastructure/SSHRC Funded Project Final Report, March 2007.

15 The Global Commission on the Economy and Climate (2014) The New Climate Economy. <http://newclimateeconomy.report/overview/>.

16 The interface between the LCE and social infrastructure investment will be the subject of a forthcoming INTEGRATE Briefing Paper.

17 European Commission (2013). Annual Growth Survey 2014, Brussels 13.11.2013 COM(2013)800 Final.

Diversifying into social infrastructure

The current pattern for Pension funds have traditionally invested in infrastructure through listed companies, as over the last two decades, investors have started to recognize infrastructure as a distinct asset class. According to an OECD report (October 2013), the ratio of the asset allocation between listed and unlisted infrastructure investment is more or less 25% – 1%. This report also states that approximately 15% is allocated to other alternative investments. The existence of a private infrastructure market shows that investment in social infrastructure can develop and grow (see Table 2 for examples).

Investor	Type	Location	Current Allocation to Infrastructure (€mn)	Geographic Preferences in the Next 12 Months
ATP Lifelong Pension	Public Pension Fund	Denmark	1.917	North America, Europa
CNP Assurances	Insurance Company	France	1.984	Global
DEG	Government Agency	Germany	823	Europe
Hermes GPE	Infrastructure Fund of Funds Manager	UK	2.853	Global
KGAL	Asset Manager	Germany	2.100	Europe
PensionDanmark	Public Pension Fund	Denmark	1.073	North America, Europa
Pensionskassernes Administration	Asset Manager	Denmark	805	Global
PGGM	Asset Manager	Netherland	4.000	Global
Prudential M&G	Asset Manager	UK	2.377	North America, Europa
Railways Pension Trusfree Company	Private Sector Pension Fund	UK	1.124	Global

Source: Preqin Special Report: European Infrastructure, November 2013

With this in mind, social infrastructure investments have the characteristics that pension funds sovereign wealth funds, insurance companies, re-insurance funds, promotional banks and others could find attractive in a specific investment context. For sure, they have considerable financial resources that they are looking to invest in new innovative opportunities. For example, in 2012, the primary institutional investors in OECD-member countries (including pension funds, insurance companies, endowments and sovereign

wealth funds, with over USD \$79 trillion in assets under management (AUM)) but had only around 1 percent of their portfolio exposure in infrastructure (\$750 billion)¹⁸.

Another significant example that helps to understand the investment potential of these funds is that in the United Kingdom alone the stock of managed funds is over £1.6 trillion although annual flow is much less. While some of this money is ‘on the table’ it is currently devoted to less than socially optimal strategies and the related needs of potential beneficiaries.

As demonstrated in Canada and Australia, bigger pension plans have made significant inroads into infrastructure assets¹⁹ as they seek to diversify assets beyond traditional asset classes. Although there are differences in the design of the pension systems in Australia and Canada, they are highly rated alongside Denmark, the Netherlands, Sweden and Switzerland. Both Canada and Australia have a trust-based pension system and both use prudent-person principles²⁰. They have also retuned the PPP model and offer alternatives to the private equity model that dominates in the EU and USA. In essence, there is both demand and a potential investing market.

Such long-term investment can be complemented with impact investments²¹ made by Charities²², Philanthropies and Venture Capital that look to achieve social and environmental outcomes including employment. They can also complement, build on and perhaps incentivise better use of European Structural and Investment Funds aligned to achieving Europe 2020 goals including employment and green energy. The current G7 Task Force on Social Impact Investment has adopted the maxim “purpose with profit”. In part, this is about creating welfare in the workplace and new employment and so more profit value. In this context, Social Impact Bonds and the emerging Social Impact Investment Partnerships provide a route for social innovation pilots at the local level testing ideas that can then be mainstreamed to complement long-term investment in social infrastructure (see also the section on ‘Opportunity: connecting employment with investment’ in Chapter 2).

Aligning supply, institutional and demand sides

A recent OECD report makes clear that moving from current investment thinking to a longer-term investment environment requires a transformational change in government

18 OECD (2012), ‘Trends in Pension Fund Investment in Infrastructure: A Survey’ http://www.oecd-ilibrary.org/finance-and-investment/trends-in-large-pension-fund-investment-in-infrastructure_5k8xd1p1p7r3-en.

19 Inderst G (2014) Pension Fund Investment in Infrastructure: Lessons from Australia and Canada. Rothman International Journal of Pension Management (7)1: 40-48.

20 Inderst G (2014): 44.

21 Impact investments are investments made into companies, organizations, and funds with the intention to generate a measurable, beneficial social and environmental impact alongside a financial return. Impact investing occurs across asset classes, for example, private equity/venture capital, debt, and fixed income.

22 Panahpur (2011). The End of Charity and the Renewal of Welfare. Tonbridge: Panahpur. This is a stimulating report that reflects on the evolution of charities and problems in social investment fund management.

and investor behaviour. Promotion of a public-private dialogue ensuring a coordinated approach between investors, the financial industry and the public sector will be a key element to develop this new “investment culture”. And yet, review of the full report shows that the “demand-side” is largely missing. Its good to get your own house in order but it is a fundamental mistake to conduct in-house reform on the institutional and investor side without also identifying how to strengthen the demand side. This means, helping the demand-side in finding out what it doesn’t know in order to strengthen its contribution to an effective new investment culture. In short, we need an ecosystem that effectively marries investment capital; public sector capacity, and social needs for that to work.

Currently, policy pays more attention to the supply side and relies on the expertise of traditional financial intermediaries, including asset managers, to inform policy. However, there is growing interest in non-bank financial intermediaries. While intermediaries have an important role in managing capital direction this should not be confused with the work needed to ensure (i) credible long-term planning and risk assessment (ii) a social alliance for appropriate regulatory frameworks that include legal and transparent actions to assure institutional investors with stable, credible lifetime activities.

As mentioned earlier, the key for developing investable social infrastructure is the ability to know when private investment is the path to go down, and right now we don’t have the best ways to sort that out with the public interest in mind. Another critical issue is the relative capacity of places and sectors to negotiate socially useful PPPs that achieve their social goals effectively.

A pre-requisite for getting answers to these questions is the need to widen dialogue and alignment between the supply (institutional investors, investment banks, intermediaries), institutional (EC and regulatory bodies) and demand (public authorities, NGOs and social enterprises) sides. In particular, if the unexplored business of social infrastructure is to be properly realised there is a need to:

- Strengthen both institutional and demand sides by incentivising a break from short-termism in risk assessment, planning and decision-making.
- Ensure that new financial products and services for longer-term investing in social infrastructure are committed to delivering a sustainable return on investment (SUROI), do not seek to marginalise or conceal risks and deliver real public value
- Provide a route for converting individual sub-sets of social infrastructure into viable options for long-term investment.

As it is just now investors don’t understand the field, intermediation is underdeveloped, and market infrastructure beyond intermediaries to support investment in social infrastructure is underdeveloped as well²³.

23 A similar and more detailed argument on these issues can be found at: Inderst and Stewart (2014), Institutional investment in infrastructure in developing countries: introduction to potential models. The World Bank, Policy Research Working Paper 6780, February 2014.

It is timely that the European Long-Term Investment Fund (ELTIF) Regulation proposed by the European Commission²⁴ will shortly be applied and can be used as a tool for this kind of long-term investment, as it provides predictability to institutional investors. In fact, the principles diffused by ELTIF are in concordance with the OECD proposals in this field, as well as with the G20-OECD High-level Principles of Long-Term Investment Financing by Institutional Investors²⁵.

PPPs are one of several routes available for project finance. Specific choices for project finance will depend on a range of factors²⁶⁻²⁷. As the Initiative for Responsible Investment in the USA has shown, attention is needed to:

- The capital absorption capacity of places (regions and municipalities) and sectors, including their ability to generate an active pipeline of buildable projects;
- Improving the dynamics of effective capital partnerships, including an equitable sharing of risks and rewards. It is the relative capacity of places and sectors to negotiate socially useful PPPs that achieve their social goals effectively that is the issue here²⁸.

Addressing gaps in what we know

As the consequences of the 2007-2009 financial and economic crises continue to emerge, the capacity and confidence to fund renewal of public services including social infrastructure remains in doubt. Indeed, recent austerity has, in some ways, offered a political rationale to retreat further from responsibility for and financing of social commitments as embedded in Constitutions.

The current situation is not the same for all countries. Australia and Canada have demonstrated how to re-work longer-term investing in social infrastructure. Relatedly, both (together with regions and municipalities in the USA) show the necessity of long-term planning and associated risk assessment on the demand side in order to reassure potential investors about key markers: stability, transparency, flexibility and systemics.

The market for innovative social infrastructure in Europe has yet to fully develop. A common challenge is how do we develop pipelines of investable projects together with effective systems and tools for service intensive PPPs that capture their public purpose. Engaging private capital might be the right choice for specific projects taking into account prevailing and projected circumstances in social sectors and places.

24 For more information about ELTIF go to: http://ec.europa.eu/internal_market/investment/long-term/index_en.htm.

25 For more information about this go to: <http://www.oecd.org/finance/principles-long-term-investment-financing-institutional-investors.htm>.

26 Inderst and Stewart (2011) – pages 9, 10, 14.

27 Vecchi V., Hellowell M. and Gatti S. (2013). Does the private sector receive an excessive return from investments in health care infrastructure projects? Evidence from the UK. *Health Policy May*; 110 (2-3):243-70.

28 Initiative for Responsible Investment (2013). *The Capital Absorption Capacity of Places: A Self-Assessment Tool*. Version 4.1. IRI and Living Cities.

But all stakeholders need to clarify the criteria and evidence by which such judgments are made. Social infrastructure has huge market potential, but it has to be better measured and analysed in order to find those innovative tools that can facilitate this business.

At this defining moment, the three stakeholder groups (supply side, demand side and institutional side) are walking in parallel but are handicapped by poor communication and understanding. Consequently, the capability to develop a viable business in this field is akin to a three-key safe-deposit box, where if all the keys are not moved at the same time in the right way, the box does not open.

What the three stakeholders bring to the negotiating table has to be reset, in order to allow them to have a wider operational horizon, where the capability of “extraction” for this business can be developed. There is still much to do in order to encourage such collaboration.

Institutional investors thinking about investing in social infrastructure

Organizing demand for infrastructure investment with high social value

David Wood

In recent years, the widespread adoption of terms including “impact investing” and “responsible investment” has signaled an apparent growth in demand for private sector investments that either generate outsized social benefits above business as usual, or investments that manage environmental, social, and governance (ESG) information in such a way as to improve reduce long-term risks (political, reputational, consumer, and otherwise) and improve long-term financial performance.¹ In parallel and occasionally overlapping discussions, infrastructure has received significant attention as an asset class that has significant social and environmental impacts and considerations in its own right, and is naturally an asset class focused on public benefit.²

In both fields – impact and infrastructure investment – motivated investors complain that they are having trouble finding deals to invest in. This complaint encompasses a number of related concerns about targeting financial investments with high social value:

- Most simply, investor return expectations – financial and to a lesser extent social – do not match what’s available in the market, and deals that do not meet investors’ expectations are unlikely to receive investment
- Impact investing and infrastructure deals are complicated beasts, requiring the coordination of multiple sectors and the balancing of multiple objectives, generating significant transaction costs for bringing them to market (investors often talk about “brain damage” in this regard)
- Clear definitions of social value in these investments are hard to come by, and mission-driven investors – those targeting social impact—find it correspondingly difficult to identify those projects worthy of extra attention and resources.

1 “Spotlight on the Market: The Impact Investor Survey” by JP Morgan Global Social Finance and the Global Impact Investing Network, May 2014, <http://www.theigin.org/binary-data/2014MarketSpotlight.PDF>. “Report on Progress in Inclusive Finance 2014” by Karin Malmberg, Principles for Responsible Investment, December 2014, http://2xjmlj8428u1a2k5034l1m71.wpengine.netdna-cdn.com/wp-content/uploads/PRI_Report-on-Progress_in-Inclusive-Finance_2014.pdf. “Global Sustainable Investment Review 2014” by Global Sustainable Investment Alliance, http://www.gsi-alliance.org/wp-content/uploads/2015/02/GSIA_Review_download.pdf

2 <http://www.oecd.org/pensions/private-pensions/institutionalinvestorsandlong-terminvestment.htm>

More investment capital, these concerns suggest, is not (alone) the issue. There is a need to work on the demand side for investment capital that targets both financial and social returns. Can we accelerate the development of deals that deliver high social value and are built to attract significant private investment?

Over the past few years, we at the Initiative for Responsible Investment, and our research partners at the Kresge Foundation and Living Cities and others, have been exploring this sort of question especially as it applies to investments in metropolitan areas in the United States.³ We have focused on what it takes to make high social value deals, projects, and programs investable – the ability of communities to attract and deploy private sector capital for public purpose.

We have focused on examining how communities can develop a more coordinated, strategic approach to organizing demand for capital and ensuring it is deployed to achieve their social and environmental priorities. This work has resonated with emerging work in infrastructure investment, in particular with efforts to link institutional investor interest in infrastructure as an asset class with public and philanthropic work to accelerate the development of high priority infrastructure investment, a topic of global interest.

In this short paper, I outline a few of the ideas we have found particularly useful in working the demand side of high social impact investment, in the hopes of generating discussion of what it means to bring investable deals that effectively serve public purpose to market.

The importance of multi-sector strategic priority-setting⁴

The importance of a community setting strategic priorities may seem too obvious or amorphous a notion to add much value to the topic of deal creation. But our work on building capacity to absorb capital that targets socially valuable investment in marginalized communities has highlighted the value of articulated strategic priorities in regional planning, when integrated with the development of a pipeline of investable deals. A coordinated method for determining strategic priorities, and overseeing their implementation, can be an important precondition for generating high-quality deals that have enough political and community support to be shepherded through the long and complex process of predevelopment. A clear set of priorities that have local legitimacy can be fundamental tools for mitigating the political and consumer risks that dampen enthusiasm for infrastructure investments.

Even in places with well-developed community plans, the planning process can be difficult to put into operation, lacking the clear signals for allocating and coordinating po-

3 For more information, see <http://hauserinstitute.org/iri/about/capital-absorption>, especially “Community Investment: Focusing on the System”, by Hacke, Wood, and Urquilla, March 2015, <http://hausercenter.org/iri/wp-content/uploads/2015/03/Community-Investment-Focusing-on-the-System-March-2015.pdf>

4 This section draws heavily on “Community Investment: Focusing on the System”, by Hacke, Wood, and Urquilla, March 2015, <http://hausercenter.org/iri/wp-content/uploads/2015/03/Community-Investment-Focusing-on-the-System-March-2015.pdf>

tential policies, projects, and capital, and needing cross-sector governance systems that allow communities to move from planning to implementation. We have seen communities in the US build multi-sector teams – with representatives from the public sector, private investors, community advocates, organized philanthropy, developers, and anchor institutions – in order to address this issue. The teams have become forums for work shopping ideas for investable projects, places to air potentially conflicting goals for how deals should take place, and stable, and more generally, durable frameworks for building trust among stakeholders over time that can mitigate some of the predevelopment challenges.

The need to develop capacity to execute infrastructure investments

In the United States, private infrastructure investment has typically taken shape through the bond markets – public finance is and will remain the most significant financing vehicle for infrastructure finance. However, growing attention to alternative financing vehicles for infrastructure investment suggests ways that public, private, and civil society stakeholders might adapt to new roles in infrastructure finance. One response to the challenge of developing deals of this type has been the seeding of capacity-building organizations that can work to develop effective local demand for socially valuable infrastructure investment. The idea here is that the political bodies who are likely to oversee the creation of potential infrastructure investments are not necessarily designed to explore new and different kinds of financing options; and there is likely a substantial information and capacity asymmetry between political bodies and places with a limited set of infrastructure needs that are suited for alternative financing vehicles, and the investment intermediaries who make such financing a speciality.

The potential risks from this asymmetry range from deals that remain undone because they do not become investable, to executed deals that do not fully serve their public purpose due to excessive private-sector value capture. One example of these capacity-building organizations has been intermediary bodies designed to identify and bring to market quality projects, such as the West Coast Infrastructure Exchange and Partnerships British Columbia.

The West Coast Infrastructure Exchange (WCX) – created by political authorities in California, Oregon, Washington, and British Columbia⁵ – was designed to help the public sector identify and nurture infrastructure investments that capture public benefits and build paths for private sector participation. The goal of the WCX is to open space for infrastructure project development and provide technical capacity to places that helps make high-value infrastructure deals investable.

Capacity development can mean the development of both the institutional expertise for creating infrastructure investments and the ability to coordinate multiple inputs into infrastructure development. In the United States, the lessons learned by Community Development Finance Institutions and public finance development agencies in blending multiple sources of public, private, and philanthropic capital seem particularly relevant

5 West Coast Exchange <http://westcoastx.com/>. Partnerships British Columbia, <http://www.partnershipsbc.ca/>

to building capacity to generate investable infrastructure deals that maximize their social value.⁶ Working the demand side for high-value infrastructure investment will require building capacity to manage the multiple stakeholders and competing priorities that are typically involved in these complex negotiations.

The value of standards for coordinating across sectors

Infrastructure investments and impact investments both are predicated on the notion that private sector participation enables the use of financial tools to create specific and outsized social value. In order to build investable projects, some set of standards that help identify which projects create this social value is especially important.

Standards are tools with which to coordinate inputs into investable projects. From the perspective of the public sector, standards can define what kinds of social and environmental benefits are required to justify public participation and subsidy in infrastructure projects. From the (responsible) investor's perspective, standards can help determine how environmental and social performance can help mitigate different kinds of risk and ensure long-term value in project development and operation. From the perspective of civil society, a transparent set of standards—and ways to evaluate potential projects against them—can prove important to building project legitimacy and mitigating political risk. In sum, core performance standards – on issues including carbon mitigation, climate resilience, labor standards, social equity, human rights, governance mechanisms, and so on – can help places prioritize which investments deserve the time, attention, and resources necessary to bring typically complex deals to fruition.

From the perspective of the social impact of infrastructure investments, standards can serve a variety of purposes. They can set thresholds that determine which investments meet the minimum criteria necessary to go forward – hurdles for project development. They can set benchmarks for relative performance, allowing for comparison among projects to determine which are best suited to deliver social value. And they can help identify which kinds of projects – or sectors of investment – are most likely to deliver high social value.⁷ The challenges of designing standards that are practicable are vital – the balance between practicability and social value must be struck in their development as well as implementation.

Developing new channels for investment

In the world of community development finance in the United States, practitioners often develop special skills at blending different kinds of capital with different risk appetites

6 Investing in What Works for America's Communities, Andrews and Erickson, eds. 2012, <http://www.whatworksforamerica.org/>

7 For examples of standards, see West Coast Exchange "Infrastructure Project Certification Principles and Framework" (December 2013) [http://westcoastx.com/assets/documents/Final%20WCX%20Standards%20Document%20\(Feb%202%202014\).pdf](http://westcoastx.com/assets/documents/Final%20WCX%20Standards%20Document%20(Feb%202%202014).pdf); Zofnass Program Envision Standards <http://research.gsd.harvard.edu/zofnass/menu/envision/>

and return expectations, allowing public and philanthropic subsidy, for instance, to bear extra risk in order to leverage additional private capital. Development Finance Institutions globally, and promotional banks nationally, perform similar function. Transaction costs for this sort of work can be high. One way to work on the demand side of high social value investments is to develop clearer paths for investors with different goals and underwriting criteria to participate in deals. [what does clearer paths mean? example?]

Similarly, creating channels for non-specialist investors to target high-social-value investments is an increasingly prominent topic in impact investing circles. Family offices and high-net-worth individuals seem increasingly open to investments that target both financial and social returns, but may find it difficult to handle complex investments or lack the ability to locate such investments and integrate them into their portfolios.⁸

Institutional investors, including pension and sovereign wealth funds, are increasingly interested in infrastructure investments both for their long-term characteristics and their role in determining broader economic performance.⁹ But they find conventional investment structures difficult to reconcile with either their financial or their social goals, and some have begun to turn to new investment structures, including direct investment or captive managers, in response to these challenges.¹⁰ These kinds of alternative channels of investment may support the demand side for high-social-value investments by marrying the needs of the end users of investment to forms better suited to serve their purposes.

Focusing on the demand side for high-social-value investments is a way of acknowledging that it's not enough to ask for investment capital to meet social needs – investments have to be designed to deliver on their social purpose, and the forms of investment must match the needs of investees in order to deliver financial returns and social benefits.

It is important to remember that this discussion is an implicit critique of business as usual. If high-social-value investments were being made, there'd be no point in talking about working on the demand side for investment. Reimagining how deals are identified, cultivated, and financed in order to maximize their social value will require extensive reflection on the roles of public, private, and civil society stakeholders, and a rethinking of how investment time horizons, subsidies, and expected rates of return are integrated into investable projects. The need for such investment is clear, but things will need to be done differently to translate that need into effective demand.

8 On this topic as it relates to community investing in the United States see Expanding the Market for Community Investment in the United States USSIF, the Initiative for Responsible Investment, and the Milken Institute (September 2013) found at: http://hausercenter.org/iri/wp-content/uploads/2010/05/USSIF_Expanding_Markets.pdf

9 On this topic see Ashby Monk, "The New Dawn of Financial Capitalism," Institutional Investor, September 8, 2014, found at: http://www.institutionalinvestor.com/Article.aspx?ArticleId=3377773#VTgsQ_D9mHo

10 See for instance the announcement of CalSTRS and APG's new program for infrastructure investment, "CalSTRS, Dutch Manager Team Up for Infrastructure Investment," Pensions and Investments April 6, 2015, found at: <http://www.pionline.com/article/20150406/PRINT/304069984/calstrs-dutch-manager-team-up-for-infrastructure>

Investing in social infrastructure

Matti Leppälä

French EDHEC Risk Institute gave a good definition of social infrastructure in their 2012 study¹: “Investing in social infrastructure means investing directly or indirectly in debt or equity backed by long-term public – private contracts for the provision of specific capital goods and their related usage in which different parties agree to take different risks and to receive their related payoffs”. Pension funds aim to develop the long-term investment environment and instruments such public partnership to facilitate investment in social infrastructure.

Different forms of social infrastructure, hospitals, schools, prisons, etc., are of course of vital importance, but social infrastructure not considered as a separate asset class. Pension funds are major investors in government bonds, and in this way have provided capital for governments to finance also social infrastructure. As a consequence of the financial and economic crisis there has been the need to shift these investments off-balance sheet as debt in public finances. Thus there is a growing need to find new solutions such as public-private-partnerships.

The future of the society is vital for pension funds. Pension funds are often very big investors in responsible investments. For example in UK, the Netherlands and in Scandinavia this is at the heart of pension fund investment policies. Responsible investments can also include social infrastructure investments.

It is vital to understand and take into consideration the primary function of pension funds, which is to provide retirement income for the members and beneficiaries. Pension funds are also social institutions, with long-term liabilities and big investors in the economy. These two issues must go hand in hand and it is crucial that pension funds are free to decide about their investment and not forced to invest even in social infrastructure. It has to be clear that the role of pension funds is not to “save the world” by themselves and they can’t substitute for the society but can’t step outside of the society either.

Pension funds need a stable long-term investment environment and this is very much linked to the policy of the governments. A government has to be stable partners and it should not expropriate the returns that were promised at the time of the investment. Social

1 Pension Fund Investment in Social Infrastructure Insights from the 2012 reform of the private finance initiative in the United Kingdom February 2012.

infrastructure investments are often very long-term and the government during the duration of investment should not change the rules of the deal. How to ensure this is not easy.

There are many barriers to this investment: regulation, fiscal accounting, etc. which should be removed. Supervisory frameworks should better understand pension fund investments in very illiquid assets. The risk based supervision of pension funds is often too short sighted and doesn't really pay adequate attention to the long-term returns. All in all, there's not enough understanding in the regulatory and supervisory framework for the long-term investments and long-term assets (liquidity issues taxation and taxes on transactions).

Pension funds need the right instruments for social infrastructure investments. Public-private-partnership is an obvious case and some have also been successful. Dutch pension funds can provide good examples and e.g. one of the biggest pension funds for the care and welfare sector has made through its service partner PGGM investment in UK student housing. The Dutch parliament has asked why are these investment been made in the UK and not in in the Netherland where there is plenty of need for student housing as well. The fund has explained that in the UK there is a better framework in place: cooperation between investors and University, the investment is big enough and the market is privatized in the UK but not in the same way the Netherlands. Thus pension funds can't invest in the Netherlands into social infrastructure in the same way as they can in the UK.

Diversification of investments is a continuous challenge for pension funds. In equity investments it is much easier to gain an effective diversification with quite small number of investments. Infrastructure and social infrastructure investment are much more difficult in this respect, which means that pension funds take much bigger risks and in the end the members of the beneficiaries are actually interested in the real returns and the level of their pension benefits. Risks taken will of course materialize.

We need stability, predictability and a framework that supports social infrastructure investments. Most of Europe is very under develop in this regard. UK experience is quite good, some other countries like Spain, Finland, have done some but not without problems. There is great potential for these investments and at the moment all social infrastructure investments are very small in Europe in comparison to what is needed. I think that there is too much focus on financial risks and we don't value enough the social impact of pension fund investments. We need to rethink and refocus how we can better take in consideration the long-term investments and their social impact.

Pension funds, insurance and infrastructure, a complex debate

Francesco Briganti

In a deleveraging world where banks are facing stricter capital requirements, there is a clear need to find new sources to finance long-term projects. Infrastructure and long-term investing are placed very high on the international political agenda. Today many policy makers want pension funds and not for profit insurance to support the economy and there is a widespread consensus that these actors should and could do more. AEIP reminds that pension funds and not for profit insurance are indeed long-term investors, but they should first abide by their fiduciary duty towards their members and cannot solve the infrastructure problem alone.

The G20 that took place in Moscow in September 2013 foresaw dedicated sessions to infrastructure in collaboration with OECD. The European Union is endorsing infrastructure investments as it is in dire need of replacing the existing and needs several billions to finance new projects.

In Europe, where credit is largely distributed by banks (according to several sources the share of credits intermediated by European financial institutions amounts to 75 % of the total whereas in the USA it represents only 30%) the situation is very pressing.

In March 2014, one year after the Green Paper on Long-Term Financing of the European Economy¹, the European Commission issued a Communication supporting infrastructure as a tool to foster European growth, to make the Union more competitive and as a result to reduce the very high level of unemployment.

In this framework some measures have been taken to review the IORP directive², which regulates occupational pension funds, and within Solvency II³ with the purpose to limit the hurdles that pension funds and insurance institutions face to invest in long-term assets. Alongside this measure, the European Commission has proposed a review of the Shareholders rights' Directive⁴ and will take action to allow third pillar pension funds to extend the field of investment opportunities. The main point that remains to be addressed is the extent of the interest for pension funds and not for profit insurance managing occupational retirement schemes to invest in infrastructure. Most experts would insist on the long-term liabilities of pension schemes and not for profit insurance

1 COM(2013) 150 final.

2 COM(2014) 167 final.

3 In September 2012, the Commission wrote to EIOPA asking them to examine the Solvency II calibration.

4 COM(2014) 213 final.

that are in line with the long-term nature of infrastructure projects; others will remind the cash flow-generating nature of i.e. toll roads or parking lots.

Many are attracted by infrastructure, as very often the design of capital requirements for investments in certain assets relevant to "long-term finance" in the EU financial instruments linked to real assets are not listed on the stock exchange and are thus less volatile. Other observers highlight the fact that infrastructure markets are highly regulated and are protected by barriers to entry.

In order to approach infrastructure in a disciplined way, one should make a first distinction between economic and social infrastructure. The first being linked to the business development of a country and the second meant to serve welfare, health and education purposes. Speaking about economic infrastructure, people refer to the energy and utility sectors, to transports and to communication. Social infrastructure refers to hospital, schools, social housing and waste managements.

The second important distinction is between listed and non-listed infrastructure. Listed infrastructure investments are those linked to listed companies whose business encompasses the construction of ports, airports, roads, housing. Listed infrastructure does not mean only equity investments, but also debt and in that space one can find several bonds issued to finance hospitals, railroads and windmills.

Some projects are identified as greenfield and others as brownfield. Greenfield projects include the planning and construction and therefore bear a higher risk. Brownfield investments exploit existing infrastructure, less risky and less yielding by definition. The choice between the two is dependent on the risk-return profile of each project, as well as the risk-profile of the pension fund.

In the current economic cycle, infrastructure investors expect double digit internal rate of returns from investments in ports, airports and telecommunication (between 13% and 15%); expectations for utilities projects are a bit more conservative around 10%.

Some empirical evidence from Australia and Canada (markets that have a long-term experience in this asset class) show that long-term returns average 10% gross returns.

Long-term investors, such as pension funds and not for profit insurance, can use infrastructure investments to serve essentially four purposes:

1. To achieve real returns;
2. To diversify their equity risk and achieve a return between equity and bonds;
3. To match their liabilities;
4. To search a return higher than the equity one.

As the reader can immediately understand, the risk associated with these targets becomes higher moving from the first to the last option.

As of today, the picture of pension funds investing in infrastructure is quite scattered. The largest players in the world are the Canadians and the Australians. Both countries enjoy a legislation that fosters infrastructure investing. The size of their pension funds also makes it easier to venture into less traditional investment decisions. Northern European countries have made some very important steps in this asset class. The Dutch in particular with their large funds have been able to attract very skilled financial professionals and implementing business units dedicated to the analysis and follow-up of specific projects.

Nordic pension funds have operated joining forces as very recently UK funds did. The situation in Continental Europe is very heterogeneous as some funds even in smaller countries as Belgium and Cyprus were ahead of the curve and other larger funds in larger countries did not venture in this kind of investments. The reality is that infrastructure represents a valuable asset class and, for sure, a viable option for long-term investors, but these latter face several hurdles to access it. Just to name the major issues investors encounter, one should remember that there is not enough comparable and long-term data relating to performances. In addition, given the absence of infrastructure benchmarks, pension trustees find it hard to compare between asset classes. Furthermore, infrastructure investments are complex to assess and difficult to access, also due to regulatory uncertainty.

The switch taking place from defined benefit to defined contribution schemes does not really favor illiquid assets as pension fund members can often redeem their assets earlier than the day they retire. Direct investments, those that yield the most interesting returns, are the most difficult to pursue as their governance and monitoring require skilled individuals and a strict discipline regulating possible conflicts of interests.

More in detail, European pension funds are mainly limited in size and resources to deploy an asset allocation including infrastructure. National regulation does not always simplify direct investments and pension regulators in some cases limit the use of the asset class in a direct or indirect way. Governments have indeed a role to play in the intermediation process: often the lack of infrastructure investments is not due to a lack of projects, but not finding the right match with investors. Some form of standardization might be investigated.

Today many policy makers want pension funds and not for profit insurance to support the economy and there is a widespread consensus that these actors should and could do more. AEIP reminds that pension funds and not for profit insurance are indeed long-term investors, but they should first abide by their fiduciary duty towards their members and cannot solve the infrastructure problem alone.

Pension investment in infrastructure: from a real disappointment to a ‘real asset’

Nicolas Firzli

Politicians wanting to update creaking infrastructure are keen to mobilise pension funds, but if they are going to persuade institutional investors to raise their allocation to roads, schools, airports and other infrastructure assets, they need to step back and think about the real needs of pension and insurance investors.

Aside from a handful of large Canadian and Californian pension funds, the average institutional allocation to infrastructure assets, excluding listed equity and municipal bonds, continues to hover at less than 1.5% of assets under management, with management outsourced to specialised asset management companies, frequently subsidiaries of US and Australian banks.

This low allocation continues, even in sophisticated jurisdictions such as the UK, in spite of the considerable time and energy deployed by Prime Minister David Cameron, Chancellor of the Exchequer George Osborne and the National Association of Pension Funds to jump-start their Pensions Infrastructure Platform to help build new roads, railways and bridges across the UK. So far, the money raised represents less than 20% of the initial annual objective, with a two-year delay.

Compounding the disappointment, most of the money is being invested in existing “brownfield” social infrastructure, including schools, hospitals and other low-risk assets rather than building new projects, which is what the politicians would prefer.

Returns, not economy boosting

Under new President Jean-Claude Juncker, the European Commission aims to raise €315 billion in the next three years through a hurriedly drafted “investment plan for Europe”. This is likely to pool public and private investments, as the Continent’s pension and insurance investors are being invited tens of billions of euros a year into disparate infrastructure pet projects from Lisbon to Vilnius. But, if they are not to repeat the mistakes made by their British colleagues, EU policymakers need to remember that the main purpose of institutional investment is to generate decent risk-adjusted returns for future retirees and policyholders, not to facilitate fiscal expediency or “help the economy”.

When they invest in infrastructure assets, pension funds and insurance companies are particularly sensitive to the fact that they become locked in over very long periods, typically more than 20 years. As the investment cycle stretches to unprecedented durations, the

respect for property rights – including legal and fiscal stability – takes centre stage. Risks relating to breaches of property rights, regulatory insecurity, limits to capital repatriation and currency debasement become all the more important because institutional investors are stuck for a very long time with what could become a sour investment because of “country risk” issues. These need to be considered ahead of project-specific parameters such as sector (energy, transportation, social), life-cycle (greenfield vs brownfield) or project size.

Country risk is key, yet it is often ignored by policymakers. It is a particularly big issue when the government can act simultaneously as long-term landlord (as with concession contracts), co-investor and/or co-manager (in the case of public-private partnerships), sector regulator influencing both price levels and turnover, client (at municipal and local level), lawmaker and, in case of litigation, judge of last resort.

This kind of risk is not confined to authoritarian regimes or undeveloped countries such as Bolivia, where President Evo Morales announced abruptly two years ago his decision to nationalise the country’s main airports. These were owned and operated by Abertis, an infrastructure concessionaire listed on the Madrid Stock Exchange. Morales argued that this foreign investor had made “an exorbitant profit with a derisory capital input”.

In 2013, the government of Norway, a sophisticated northern European jurisdiction with an independent judiciary and business-friendly laws, informed a group of co-investors led by Canadian pension funds Canada Pension Plan Investment Board and PSP Investments, German insurance powerhouse Allianz and Abu Dhabi’s sovereign fund Adia of its unilateral decision to cut gas transport tariffs. This degraded the value of their \$5.1 billion stake in Norway’s Gassled natural gas transportation infrastructure.

And in France, a group of toll-road operators in late January threatened to sue the government after an annual toll rise of barely 1% was blocked. Moody’s described the move as “political interference” and said it could damage the operator’s credit ratings.

More protection needed

National governments and Juncker must do their homework before inviting pension and insurance investors to put their money into enticing infrastructure assets in Europe or elsewhere. They need to ensure that there is a level playing field, offering them iron-clad protection against governmental tampering and strong, actionable recourse in case of contractual breach. Until then, the “rise of real assets” will remain a real disappointment.

The Scottish independence referendum of September 2014, which nearly saw the victory of the Yes vote, the possible Greek withdrawal from the Eurozone in 2015 and corollary default on up to 50% of that country’s sovereign debt, not to mention Iceland’s banking debacle in 2008 that cost British and Dutch taxpayers billions of pounds, are here to remind us that country risk is a real and present danger, even in “investment-grade” OECD member states, once supposed to be infallible.

As physical infrastructure is substantially hard to sell and considerably more complex than plain vanilla government bonds, it is all the more important for policymakers, central governments, states and municipalities to walk the extra mile for legal safety and regulatory even-handedness. Pension and insurance investors will want to see rock-solid protections from government before partnering it on a large, economically meaningful scale.

There have been some promising signs coming from Washington, DC lately. In its annual World Economic Outlook published in October, the IMF, an institution long

sceptical about the need for and the effectiveness of massive investments in highways and high-speed railways, adopted a more centrist stance, saying that “increased public infrastructure investment raises output in both the short and long-term... the time is right for an infrastructure push” in both industrialised and developing nations.

The World Bank Group also announced the Global Infrastructure Facility, backed by the governments of Australia, Japan and Singapore as well as key private-sector and supra-national partners, to foster institutional investment in emerging and frontier markets infrastructure projects.

In terms of domestic US politics, there is new-found bipartisan momentum in favour of infrastructure as an asset class. In President Barack Obama’s State of the Union address, one of the few initiatives that got a positive Republican response was his plan for a new type of municipal bonds to spur joint public-private investment in socially beneficial projects.

These are positive signs. If governments can play their part by offering the necessary protection, it is just possible that those highways, railways and other real assets necessary to keep our economies growing may actually get funded – and built.

Social infrastructure: private finance and institutional investors

Georg Inderst

Only ten years ago, infrastructure investment attracted little interest in Europe and North America. This has changed for the better. The main focus of the current debates is on economic infrastructure, especially on transport and energy networks. In contrast, social infrastructure investment has received surprisingly little attention, at least so far. This should change.

In this article, we make some observations and comments on private finance of social infrastructure and the role of pension funds, insurance companies and other institutional investors. In fact, there are some interesting developments in the markets but they are often overlooked.

We first sketch the current state of social infrastructure investment and the various sources of finance. Second, we briefly discuss some specific characteristics of social infrastructure from an investor perspective. Third, there is a reminder on some conceptual and data issues in this field that need to be worked on. Here we concentrate on “hard” or “physical” infrastructure, being aware, of course, that there are other definitions that cover “soft” factors and “intangible” institutions such as education, health, security or culture.¹

Social infrastructure investment

Investment in social infrastructure is a considerable factor in the economy. Wagenvoort et al. (2010) *Infrastructure Finance in Europe: Composition, Evolution and Crisis Impact*, calculated gross fixed capital investment figures of roughly € 100bn per year in the EU health and education sectors (2006-2009). In other words, social infrastructure contributes about 1% to GDP (0.6% in health and 0.4% in education). It constitutes more than a quarter of total infrastructure spending. This is not insignificant.

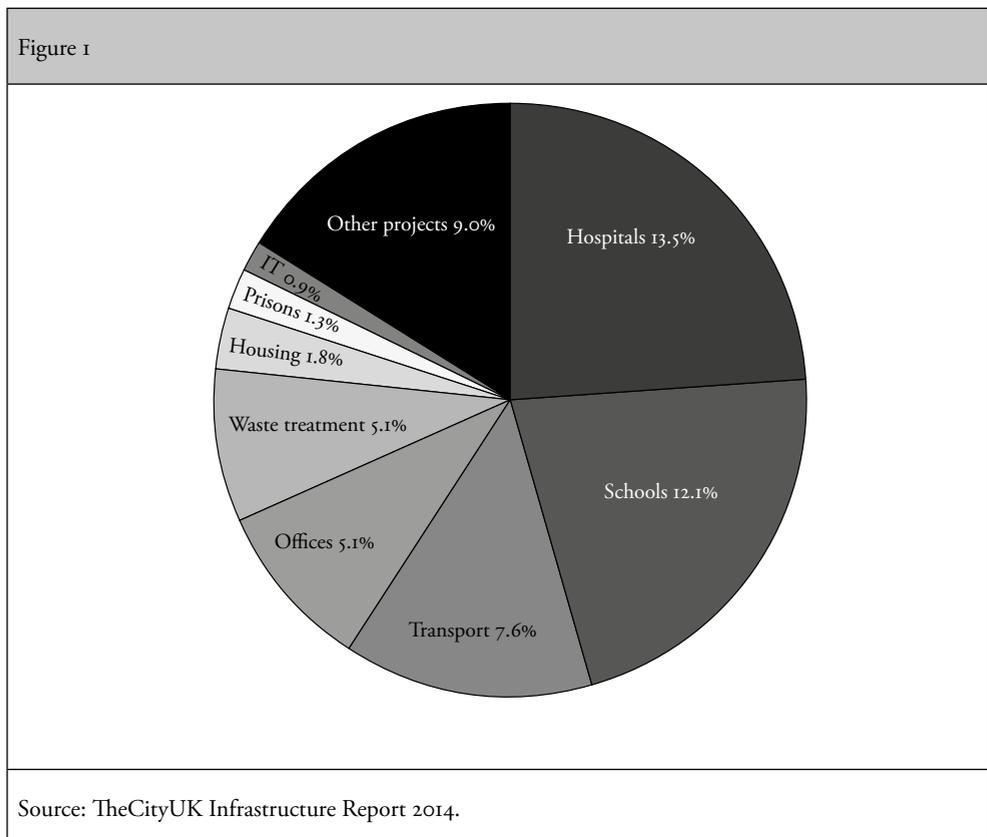
There are major differences in the financing source of the two sectors. Investment in education infrastructure is nearly 90% government financed. Health infrastructure is about two thirds privately financed, mostly by the corporate sector, which is broadly in line with the financing pattern in economic infrastructure. Furthermore, we learn that public-private partnerships (PPP) are about twice as important in social as in economic sectors. However, still only 6-7% of social infrastructure investment in Europe runs through PPPs, and this is rather concentrated in a few countries.

1 Example of a definition used in the financial markets: “Social infrastructure can be broadly defined as long-term physical assets that facilitate social services – typically schools, medical facilities, state or council housing and court houses, among others.” (Preqin 2014)

What do we know about the future investment requirements in social infrastructure? Little to nothing. All the major studies in this field, including by the OECD and World Bank, concentrate on economic infrastructure, which is already a difficult task. It also needs to be said that academic research is still in its infancy in this field.

Looking further into European PPPs, the overall value has been in the range of € 12-30bn p.a., i.e. about 0.1-0.2% of GDP, according to EPEC. Transport is by far the strongest sector in terms of volume while the number of (smaller) deals is highest in education. About 45% of the European PPP volume since 1990 happened in the UK.

The UK Private Finance Initiative (PFI), a form of PPP, reached 732 projects between its start in 1992 and 2012, with an aggregate capital value of £ 56bn. It has indeed a strong focus on social infrastructure, with 24% of the volume in hospitals, 21% in schools, 9% in offices (e.g. fire & police, courts, service centers), 3% in housing and 2% in prisons (Fig. 1). However, volumes have been low in recent years.



Institutional investor activity

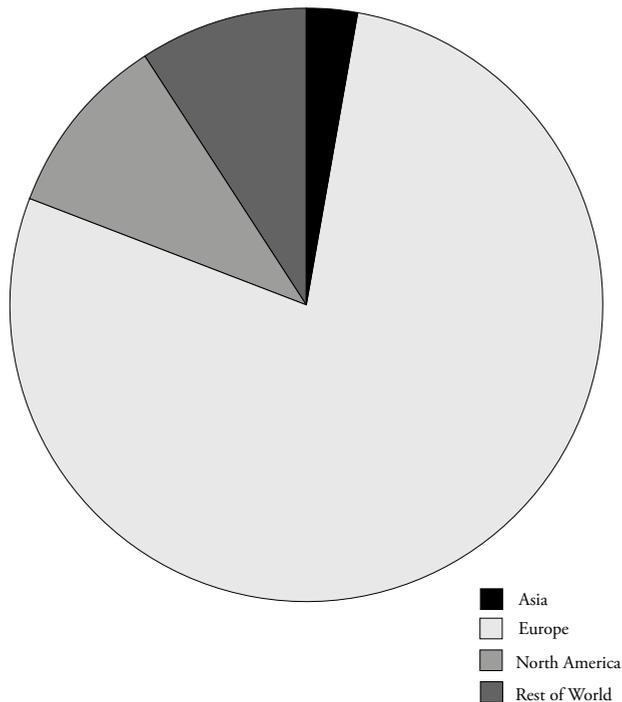
Institutional investors worldwide have increased their interest in infrastructure in recent years, primarily via unlisted infrastructure equity funds. Most of the capital goes into transport, energy and utilities but social infrastructure typically has a weighting

of 10-20% in these funds. According to data provider Preqin (2014), 13% of the global transactions since 2008 have been in social infrastructure. Interestingly, Europe captured 78% of social infrastructure deals (64% in the UK), i.e. an annual transaction volume of about US\$ 20bn (Fig. 2).

We should not forget that institutional investors have even larger investments in equity and bonds of listed infrastructure companies, such as energy and water utilities. However, social infrastructure plays a very marginal role on the stock markets. Exceptions are some infrastructure trusts or closed-end funds on the London and Sydney stock markets, such as John Laing Infrastructure Fund or HICL, that have heavy weightings in PPPs and other social infrastructure projects.

Infrastructure debt investing has been taking off in Europe over the last 2-3 years. There have been some PFI or PPP bonds in places like the UK and Canada. Project bonds are having a recovery these days, and there is certainly more potential also in the social sectors.

Figure 2



Source: 2014 Preqin Global Infrastructure Report.

Some of the larger pension funds, led by Canada, have started to invest directly in infrastructure. A number of Dutch, Nordic, German, French and other pension funds are already venturing not only into schools and hospitals but also social housing, care homes, student accommodation and stadiums.

Pension fund investment platforms, such as the UK PIP, will also extend such activity. Insurance companies in particular are increasingly searching yield via direct infrastructure loans. Also some Sovereign Wealth Funds have social investments in their remit. Overall, Preqin reports that 16% of direct infrastructure deals happen in social infrastructure.

There are also other financing developments such as Social Impact Bonds (SIB), as launched in the UK, USA and other countries.²

A number of foundations, charitable trusts and pension funds (such as the Great Manchester Pension Fund and the Merseyside Pension Fund) have taken an interest in SIBs, alongside venture capitalists and other investors.

In a nutshell, there is already some private investment experience in this market. However, institutional asset allocation to infrastructure is only 1-2% on average globally and in Europe, and with social infrastructure taking 10-20% of that, we are still talking about small exposures. There is potential for more.

Specific characteristics of social infrastructure

Asset owners also need to become more accustomed to social infrastructure investments. There are some specific characteristics, some of them more favourable investors than others.

Size: Projects in health, education and other social logistics are comparatively small. The median PFI project value is less than £ 50m. For large investors, they are often not worth spending their time on:

Funding: The cash flow comes mostly from availability payments by the public sector. Some investors prefer this to the user fee assets, where the consumer demand can be very volatile, e.g. in transport.

Investment vehicles: Typically, social infrastructure is mixed with other sectors, although there are a few specialist products on the market. Smaller investors in particular would need more well-diversified (and cheap) funds.

Risk and return: The contractual arrangements of social PPPs are often seen as relatively “low risk” by investors, with return projections in the single digits. However, they are typically highly leveraged which can be yield surprises in difficult times.

Inflation-protection: Cash flows of social PPPs are often inflation-linked which is useful for investors with inflation-linked liabilities.

2 A Social Impact Bond is a contract with the public sector in which a commitment is made to pay for improved social outcomes that result in public sector savings. They have been used to tackle entrenched social problems such as short term offenders and youth at risk.

Operational issues: Poor service quality and inefficiencies seem to be notorious in these sectors. Therefore, good contracts and management are paramount.

Regulatory, political and social risk: There is always an element of political risk, as change of regulation and renegotiations are not uncommon in this field. There is also “social risk” and “reputational risk” if a PPP projects is opposed by pressure groups or the media.

Risk-sharing: It is not easy to find the right and fair risk-sharing arrangements, and circumstances can change. In the UK, for example, PFI was criticized for being too expensive, too opaque, too slow and too inflexible. According to critics, the private sector could make windfall gains while the risk transfer and future liabilities for the public sector were unclear.³

The UK government introduced a reformed version in 2012. PF2 tries to address the criticisms with a number of changes, including a public equity stake, faster procurement times, easier renegotiations and more transparency.

Overall, social infrastructure projects can have some interesting characteristics for investors but can also be small and fiddly, and necessitate cost-effective investment vehicles. Consistent infrastructure policies with a clear regulatory framework and good public governance are essential longer term. Governments need to be trustworthy over the longer term.

Conceptual and data issues

There are major definitional and data issues in the infrastructure investment discussion. Very different concepts (e.g. economic, sectoral, contractual, regulatory, investment characteristics) are being used in the political, financial and academic world, and there are a lot of grey and controversial areas (Inderst 2013).

Public infrastructure normally has a connotation to large physical structures in the economy with a network and/or monopolistic element. But many social infrastructure assets, such as accommodation for students or the elderly, are very similar to (smaller, private) real estate assets. Some funds even contain football stadiums, leisure parks, casinos and other entertainment facilities.

This may help increase the investment universe but the question remains how far it can be stretched, especially when fiscal incentives and regulatory exemptions are involved.

Finally, infrastructure statistics need to be interpreted very carefully. Unfortunately, the data that is scattered around many places (e.g. national accounts, financial transactions, investment fund tables, investor allocation data and surveys).

Private data sources can be expensive and not very transparent. National and international organizations could do a lot of “public good” by improving the statistical

3 Vecchi et al. (2013) analysed the cost-efficiency of PFI projects in the UK health sector. Expected returns by the private sector far exceed the underlying cost of capital (by 9%), despite the ‘low risk’ nature of availability-based payments by the public sector.

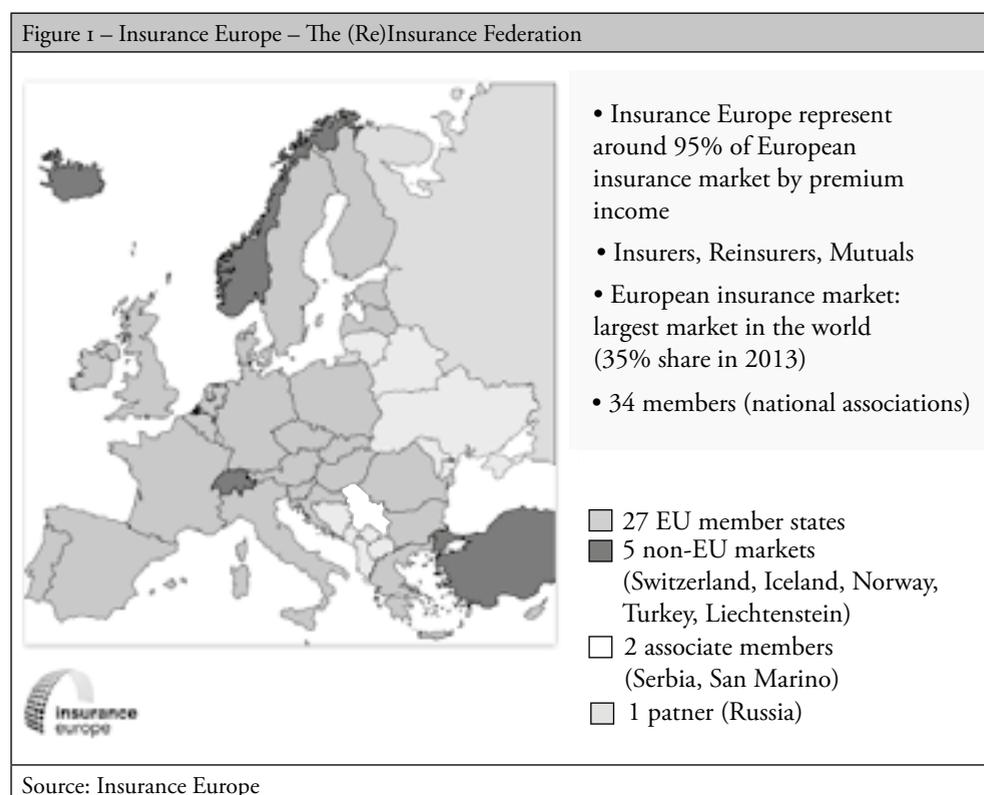
information. “National infrastructure plans” can certainly help focusing peoples’ minds, also in terms of data requirements.

In summary, we still know very little about (tangible) social infrastructure investment, and even less so about future needs. In practice, private finance already plays a significant role in Europe, in some places more than in others. However, there is room for further development of PPPs and other forms of private participation. Some institutional investors have become active in social infrastructure but overall volumes are still very small. Good infrastructure policies, a consistent pipeline of investable projects and adequate investment vehicles would be required.

The role of insurance companies

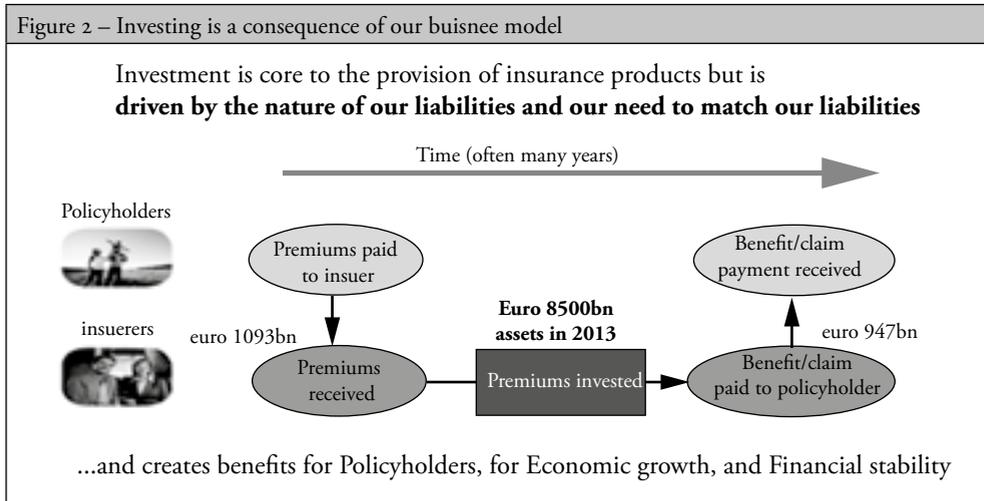
Olav Jones

The challenge is from the supply side in terms of financing projects including social projects. But many of the issues that we face with financing social projects will be common for financing infrastructure and general investment.

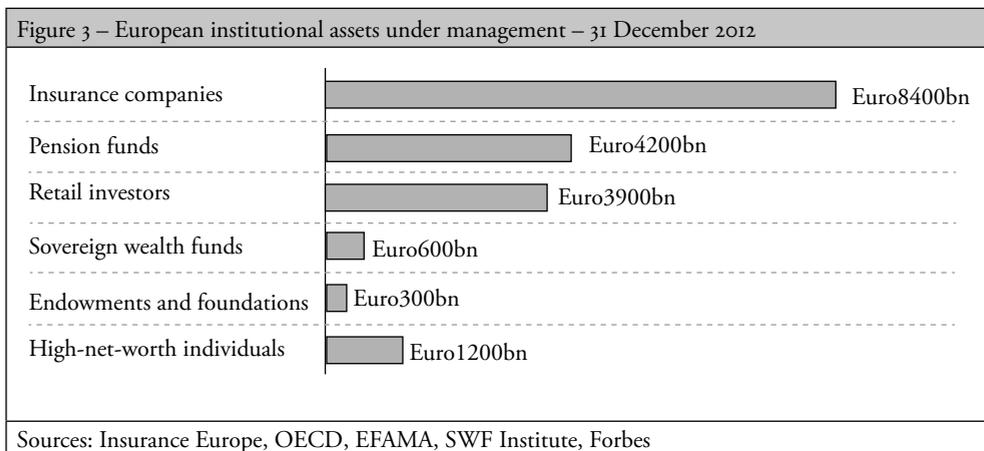


I'm from the Insurance Europe. We represent the Insurance industry across Europe and we cover Insurances, Reinsurance, Mutuals etc. The Insurance market in Europe is actually the largest of the world. We have significant interest in this topic. Because of our business model we are major investors.

It is important to remember that our business model is different from banks in the sense we get cash in the form of premiums up front from customers and then we have to invest this over a period of time. Often that period of time can be many many years, can be up to 70/80 years in some markets because of the products. This allows us to be long-term investors.



In doing so we can create benefits for policyholders. As side effect we can also create significant benefits for the economy in terms of growth and financial stability because we can be, in line with OECD definition, long-term stable patient investors.



Long-Term Investments: We welcome the new Commission's focus on investment and growth

- Provides opportunity to consider in a wider context the industry's long-term investment objectives and Europe's investment needs

- Explore solutions to enable insurers to maintain and grow their role in providing long-term financing
- We recognise the interest in asset classes which can have the most immediate impact on growth
 - Infrastructure investments (equity, bonds, Project Bonds, PPPs)
 - Securitisations
 - SME investments (equity, bonds, private placement)

Because of this business model we have currently over eight and half trillion of assets under investment. We very much welcome the focus on long-term investments and commission focus on this topic because we think there are number of things that need to be addressed. There is plenty of money to potentially invest – we definitely have a lot, the pension funds have a lot, but the question is what is stopping the money getting to the right places?

We are also very proud as insurers of the role we play not just in providing returns to costumers but how we can play a role in society. We know the costumers like the idea of knowing how their money is invested and can see it being invested in their community and across Europe. So from that point of view we have double benefit.

While we are interested in all type of assets, we understand why right now there is a particular interest in type of assets that can have most immediately effect on growth and employment in Europe. So that doesn't means the other types of assets, such as corporate bonds and general investment in the stock market are less important to us. But we do understand where the focus is on infrastructure, securitisations, and SME investment, given the need in Europe to restart growth and employment.

Steps to unlocking insurers' potential capacity to invest in real economy

1

1	Maintain/grow inflow of premiums for investment
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- We can only invest if we get premiums – eg policymakers need to look carefully before removing incentives to save – eg tax incentives

2

2	Improve supply and access to suitable assets...
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3

3	Avoid and remove regulatory disincentives
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When we look at this problem for us we see three things policymaker should take into account:

- 1) To keep the flow of premiums policyholders. People will need education and probably tax incentives to help ensure they put enough money into saving for the long-term
- 2) Then we have the problem of their not being enough suitable projects to invest in – we need significantly more
- 3) Finally I am going to look at the regulatory disincentives that need to be removed because they are or will prevent insurers from being able to invest

About the barriers. Some of the issue where we identified a lack of supply suitable investments. We really hope the pipeline project, we now have two thousand projects in a pipeline, could help so that, there are things happening to help to address the issue. We have also a concern about the lack of standardization and documentation, contracts etc. Again we see the investment plan having elements around standardization insuring high quality documentation, allowing our company to do the own risk assessment. So these things we hope we'll be addressed.

We also think the need to to look at deal sizes. It's been mentioned that in some companies need large deal sizes – some companies seek investments from 10 million to several hundred Million and will take significant part of both the “greenfield” early investment stage, equity stage as well as the later operational “brownfield” stage.

However there are also companies who want small deal sizes even below 1 million euros. So it needs to be possible to take syndicate – take part of the total exposure.

It's important the projects are divided clearly in this greenfield and brownfield stages. There are some companies interested in the greenfield and they would like access to that at lower cost to more efficient access, but the most will intent be interested in brownfield or bond types of investment. We think the investment fund (EFSI) from the investment plan could help because there are ways you can take greenfield risk investments and use the guarantee within the fund to turn the investment into bond type of investments that may appeal to wider group of insurance.

Political risk is a very important concern. If the company is going to invest for twenty-plus years they need to be certain the deal will not be changed. The contracts and agreements and the environment tax, etc around the deal. And we have had unfortunately recently some bad experience in the industry where some very large deals have been changed after the investment has happen and it has really jeopardized the entire investment. And that has frankly given insurance cold feet about going into these investments. The political issues will be a challenge to “solve” but if there is determination to do it, it can be addressed.

Solvency II calibrations of long-term investment are too high compared to the real risks

- Strong support of a risk-based approach, but vital to measure based on the true economic risk exposure
- Despite improvements, SII still assumes insurers act like traders and are faced with same risk as traders – still undervaluing how long-term liabilities can reduce exposure to market volatility
- Example 1: capital charge for 5 year AA high-quality securitisation

Original Calibration (QIS5)	80%
EIOPA proposal (end-2013)	42.5%
Final calibration (Sept. 2014)	15%
Actual default during entire crisis period	0.14%

← Spread-risk approach

← Default-risk approach

- Example 2: capital charges for infrastructure

Infrastructure equity (<i>treated same as hedge funds</i>)	49% (+/-10%)	
Infrastructure 25year bond AA (treated same as corporate bond)	16%	← Spread-risk approach
Worst level of actual defaults in crisis period for AA corporate Bonds	0.38%	← Default-risk approach

3) Avoidance/removal of regulatory disincentives

- Good regulation is important for healthy industry
- A raft of regulatory changes can affect insurers' investment behaviour, including:
 - Prudential (Solvency II)
 - Accounting (IFRS 4 Phase 2/IFRS 9)
 - Derivatives (EMIR)
- Regulation and design of the supply side is also key
- Regulations must take into account the distinctive characteristics of insurance industry

Now on to the regulatory issues and dis-incentives: With both Solvency II and IFRS accounting we need to make sure that for invest long-term they don't create artificial volatility and exaggerate the risks. These rules have to be designed to make sure they allow us to represent the business model as it is – that's still a challenge for us. Even derivative regulation can cause some problems because it forces us to hold too much cash which means we have less to invest in real assets.

About Solvency II. We very strongly support a risk based approach. We have been supporting that all the way through the development of Solvency II, but the key question is what are the real risks we are facing. And this where we would have some discussion around the calibration for Solvency II. There is a lot of criticism around the calibration of for securitisation. The original calibration of 80% for AA 5 Year High quality securitisation has been reduced to 15%, that's great, because 80% would clearly kill the market. But 15% is still very high when compared to the actual default during the crisis period of only 0.14%.

So in term of conservativeness we have some questions. Likewise for infrastructure the AA 25Year infrastructure bond will cost 16% while actual defaults rates for AA rated bonds have only been above zero twice in the last 40 or so years – and one of these – in 2008 I believe, was only 0.38%. So again we believe the capital charges are far too conservative and this will create dis-incentives to invest. So these capital charges need to come down to better reflect the real risk.

The role of trades unions

Fausto Durante, Claudia Menne

Long-Term Investing is gaining momentum and Social Infrastructure are growing as a big player for growth and employment. This is the moment to better analyze the shift in financing paradigms occurring in Europe: from the use of fiscal resources to the opening to Institutional Investors as Pension Funds, Insurances and Sovereign Wealth Funds, from the almost-pure “bank financing” to the entrance of a “non bank financing”.

Long-Term Investing in Social Infrastructure is a new frontier both for supply side and demand side, asking new performances to institutional side.

The CGIL, which is the largest Italian trade union and that is part of the European Trade Union Confederation, has already launched a year and a half ago the proposal of a new Plan of Work for 2014 that now is ending unfortunately without it has never been discussed with the Italian political authorities, following in this the same fate of the proposal from the European Trade Union Confederation.

ETUC, which represents 88 national unions in Brussels, presented a special plan of investment for growth and youth employment in Europe with the ambitious name of New Path for Europe. Also in this case we have never been able to discuss this proposal with President Barroso but we sincerely hope that the new Commission chaired by Juncker will find time to address the issue of investment and growth with workers' organizations in Europe to better define the contribution that we can bring to this discussion.

As you can imagine in the world of European Union it is so hard to find a unity of purposes and a common position on the issue of investments for growth, defining which areas to boost development in Europe and especially by what means to finance this plan.

However, also because of the destroying economic crisis that during these years has severely affected the lives and working conditions of people in Europe, we were able to put together different political and cultural settings in the trade unions in Europe and we were able to agree on some guidelines.

We need to change the economic policy of Europe as it runned in recent years because it is not capable of solving structural problems, put the debt under control, ensure growth in Europe, reversing the trend of the growth for young people, preventing Europe to hook the train of recovery.

We must put aside the austerity and go towards a policy of investment for growth. The proposal from the European Trade Union Confederation, at the end of a journey

that saw the CGIL propose the Plan of Work, could be synthesized in the the DGB German proposal of a New Marshall Plan for Europe, all summed up in New Path, asking for Europe to invest 2.500 Billion EUR (250 billion a year for 10 years).

This is much higher than the sum of the Investment Plan of Juncker that is largely insufficient.

Where to invest these 2,500 M Euro? We must reindustrialise Europe, because it is losing competitiveness as a whole, even in those countries that have made the tow.

Our colleagues from the German trade union know perfectly well that if we do not reverse this trend to impoverishment of the technological capacity of the corporation in the production process of research and development as well as the impoverishment of wages, there will be no possibility for those living of employment, salary, or the vast majority of the population in Europe, to buy their manufacture.

So we need a big project of re-industrialization that must take place in a socially and environmentally sustainable way that is not just a problem of southern Italy. Then we have a great theme to return to invest on ICT (Information and Communication Technology). A continent like Europe which is trying to integrate more and more, can no longer afford, worth the inability to compete, 28 national systems of production and distribution and sale of electricity, 28 national champions in telecommunications, 28 different systems for transportation and logistics, etc. we must continue investing money in the interconnection of networks and competitive capacity of the systems and infrastructure in Europe.

And the third major strand in which to invest is what concerns related to social infrastructure first of all those necessary to active aging policies that take account of demographic trends.

Europe is the most attractive place in the world to be born, live and work. We need to ask the theme, speaking of social infrastructure and investment devoted to socializing, the issue related to the time of life when you finish work experience, which can not be resolved, for example. with the carers.

We must instead play at European local welfare systems, such as in USA, Canada, Australia and we must be aware that investments on welfare can have economic return, or new jobs that provide income and wealth.

Two additional themes on which we discussed recently and tried to speak with the government, or two emergencies: the need to invest in the school and vocational training, and the other is the cultural infrastructure which is the historical, artistic Italy to invest, the greatest heritage all over the world.

It is necessary and possible to find financing of this plan, because it is not unproductive expenditure. If we were able to find money to save the banks, perhaps you can find resources, speaking on large estates, on tax evasion, the illegal constitution of capital abroad, strongly revising the regulations on tax havens, putting the resources in a large European fund and the funds of private individuals, that the European Investment Bank to try to reverse the decline and to restart the European recovery.

Models of cooperation between institutional investors, promotional banks and European Structural & Investment Funds (ESIF)

Giorgio Chiarion-Casoni

The institutional support to investment, as drafted in the Commission Communication of 26th November on an Investment Plan for Europe, the so-called Juncker package, is organised on a three strand structure:

1. The first, and most visible, is mobilising finance through the European Fund for Strategic Investments (EFSI): the idea is to mobilise more than EUR 300 billion of finance towards investment projects. I would like to dispel any doubt concerning the objection raised that no new money would be available: the EU budget provides a guarantee of EUR 16 billion, which together with an additional EUR 5 billion risk bearing capacity from the European Investment Bank (EIB), will allow the latter and the European Investment Fund (EIF) to invest an amount of more than EUR 60 billion. The key point is the complementarity of this kind of finance: the idea is that the EU guarantee would allow the EIB Group, also flanked by national promotional banks, to take the risky pieces of individual project loans and finance. This includes for example subordinated debt, equity or quasi-equity type of investments, whereas senior type of financing would be reserved only for riskier counterparts. This approach should attract further private and public finance of EUR 250 billion, hence mobilising a total investment of more than EUR 300 billion.
2. The second leg of our plan is setting out an environment that eases investment: improving predictability, quality of regulation, reduction of macro-economic uncertainty, improving tax systems, and in particular the removal of sectorial barriers to investment which are present in some key investment areas like energy, transport or digital agenda. The Commission is working with great enthusiasm in tackling such issues as from the outset of its mandate.
3. Finally the third leg, on which I would like to focus today: the development and preparation of a sound project pipeline, what makes this project pipeline reach maturity and fruition and these investment to happen.

The starting point is that there is a disconnection between liquidity and financing available on the market and the scarcity of investable projects. There is a widespread perception that projects do not exist in Europe, Italy is a typical example, but all European

countries face the same problem: projects are not only slowly prepared but they also lack visibility on the market. These conclusions were reached also by the OECD and G20. Our intention, by creating the Task Force on Investment composed of the Commission, the EIB and EU Member States was mainly political: we wanted to show that projects exist and that there is a potential for investment in Europe. We identified more than 2000 projects both at Member State and European level. It was not possible for the Commission or the EIB to assess all these projects, but all Member States in three weeks made a huge effort of coordination and cooperation among their ministries leading to the identification of this pipeline.

The pipeline identified by the Task Force is just a first step towards more forward looking structure of setting pipelines in Europe to increase stability and transparency. We have some examples from UK and the Netherlands, where national pipelines/investment plans are defined, clearly stated, and published in a website. Following a summary analysis, these projects are listed, indicating financial needs, stage of maturity, potential bottlenecks and further steps. The projects can go in and out of the pipeline. As an external investor, the existence of such transparent pipelines provides a certain reassurance about its stability and credibility (even in a situation of change of political direction, it would be more difficult to revamp completely the existing pipeline). Moreover, it facilitates contacts with procuring authorities with a view to discuss projects and help them structure better. This will help manage expectations, which is the ultimate aim of the exercise.

Our aim would be that all EU Member States would define clear long-term investment plans, detailing in a centralised manner all projects that are supposed to be implemented in the next period to facilitate discussion not only with investors but also with civil society, given the potential impact of new investment projects on the society as a whole. At the same time, the Commission would like to replicate the mechanism for projects at EU level (cross-border projects, trans-European network, projects that are financed through structural funds).

In order to facilitate the preparation and development of projects, the Commission will propose the establishment of a European Investment Advisory Hub to be managed by the EIB.

Finally, in order to avoid confusion, it is important to stress that it is not because the project is among the 2000 ones listed in the pipeline identified by the Task Force that will be financed by the EIB under EFSI. Likewise, also projects that are not in the pipeline can be financed with the support of EFSI.

I would conclude by informing you that the report produced by the Task Force is publicly available on the Commission website and the website of the EIB. The report does not only focus on projects but provides a very interesting insight on barriers and bottlenecks pre-empting investments in the different sectors. This analysis has inspired our proposal for an investment plan and further regulatory activity.

Sectoral and regional opportunities

Debating the role of the institutional side in relaunching investing in social infrastructure

Michael Hornsby

Long-term social and infrastructure investments in Europe offer great potential opportunities for both investors and those seeking positive social outcomes. This is, however, a complex market which crosses borders as well as social boundaries.

It is a market which combines public and private capital sources, and whose success is measured both in social and financial outcomes. This paper is based on a panel discussion held at a conference in Rome, “Investing in long-term Europe: Re-launching fixed, network and social infrastructure”. It investigates the roles, that different institutions, intermediaries and advisors can play in connecting the supply of capital looking to invest long-term for both financial and social impact returns, and the demand for capital from a wide range of social and physical infrastructure projects within the EU.

There are some obvious inherent challenges, when looking at the structure and dynamics of this market. There is, for example, the big challenge to establish real connectivity between the supply of institutional and public money and the broad range of projects existing in the European market, operating on many different levels, where the combination of financial and social outcomes might not be obvious.

How are potential projects identified and selected? How can both social and financial goals be aligned? What is the most effective way to use public funding, if available? Can projects be aggregated into larger more “investable” vehicles, which better diversify risk for investors? What types of governance and oversight models are most appropriate? Can government policy have a positive effect on this market by, for instance, providing incentives in areas such as tax and financial regulation?

At the root of this debate, there is the fundamental question, as to what extent can public expenditure and private social investment programs (philanthropy) be combined effectively in appropriate vehicles, potentially alongside financial investors seeking both an exposure to impact investing, as well as meeting economic return objectives.

The degree, to which this can be achieved invariable, depends on the nature, size and compatibility of the projects, which make up the investment program. One obvious role for institutions is to somehow act as “market makers” as well as investors. They can do this at various levels by providing not only the capital, but also the expertise in identifying and structuring deal flow and packaging projects into the appropriate vehicle. The overall objective here is to maximize the leverage effect of philanthropic capital, which seeks only a social return, to efficiently working alongside institutional capital.

We started our panel by examining the role of European institutions at a more macro level represented by Giorgio Chiarion-Casoni, Head of Infrastructure Unit DG ECFIN. Giorgio leads a taskforce set up by the European Commission in collaboration with the EIB and the EU member states, which has identified and analyzed some 2000 long-term investment projects all over Europe. This initiative aims at tackling low investment activity and improving the average attractiveness of post-crisis Europe on a long-term and sustainable basis as part of the Juncker initiative. The projects identified in this program cover a wide range including infrastructure, transport, energy innovation and digital economy, all aligned with the general objective to foster European growth.

The scale of such projects is generally of large public interest and on national and trans-border EU level. The three main findings of the taskforce are summarized and illustrated in the resulting report:

Firstly, the need to ensure adequate financing of these long-term investments by assuring, that required resources are available at a commission level and that the projects are capable of attracting sufficient private money to bring them to fruition; secondly, stressing on the importance of establishing the right economic environment, which can be shaped along with the support of the relevant states, ensuring that it is not too cumbersome, by including key features like equality of regulation, favorable tax systems, reducing macro-economic uncertainty, political stability, transparency, predictability, accessibility; and thirdly, ensuring the visibility of the projects through media and marketing instruments, making the investors and the public aware of these opportunities.

The concrete idea behind this initiative is to create a pipeline of opportunities open to private and institutional investors. Pursuant to this, the program requires to mobilize member states at a national level, but also to co-operate cross-border, to identify, qualify and promote this type of long-term sustainable investment. The pipeline acts as a medium to connect supply and demand and to attract the respective investment resources. If this can be accomplished, the large scale of this initiative could have significant positive social outcomes, especially if it is able to attract a large public interest of return seeking investors.

At the other end of the scale, the panel discussed small, local, philanthropic investment programs, often run by purely charitable organizations with no clearly measurable financial outcomes, which operate in many forms across Europe. A good example of this type of situation is a program running in Italy, represented in the panel by Luciano Balbo and the European Venture Philanthropy Association, with which he is associated. Luciano described, how the social investment programs, he is associated with, happen mainly on local and regional level, often concentrating on deprived areas with low economic activity and a high level of unemployment. Areas of investment include education, health care and social housing schemes.

The strategy of the association focuses on investments that create a positive social impact that is sustainable. Luciano makes the point, that operating in the field of social venture capital mostly aims at driving positive rather than direct economic social outcomes, and the nature of these investments bears a high level of risk. Therefore, investors

are mostly found in foundations and charitable organizations, with some private donor involvement and with limited involvement at larger institutional level.

A potential source of capital for these types of projects could also include public funds that work alongside existing donors. Given its nature, role and responsibility, the public sector cannot always take the respective risk to invest into such social innovation and get behind the development of new models that are necessary to push these kinds of regional projects. Luciano stresses, that existing financial resources on a public level are often adequate as a whole, but need to be allocated in more efficient ways.

Public institutions need the flexibility to address the demands of social innovation. Also, such programs need to investigate the opportunity of creating public private partnerships that allow outsourcing of risk. The key is working with local governments, building relationships and generating the trust, necessary to facilitate alignment around common investment projects.

The reality is, that pure philanthropic projects such as the above, present a serious challenge in terms of linking them to institutional markets due to their inherent size and nature. Is it possible to bring these two worlds together? The European Fund of South-east Europe ("EFSE"), represents a successful example of exactly this idea, combining donor money with institutional investors looking for financial and social outcome.

The latter, as addressed in the funds' mission statement, focuses on generating impact on three different levels: investing in micro and small enterprises to strengthen local economies through generation of income and creation of jobs, ensuring that basic needs of individuals are satisfied via housing projects and supporting local financial markets.

The fund is organized as a public private partnership and fed through funds from various donor agencies and European governments, international financial institutions as well as private investors. It is structured as a real business with efficient and regulated governance, oversight and accountability. Risk management is addressed in its "first loss" tranche, set up through existing donor or public capital, which intervenes at the very beginning in the event of losses. Figures and statistics substantiate that the fund is operating successfully by meeting expectations of the different parties involved.

Looking at the structure of the fund, it becomes obvious that the overall construct is quite complex. The fund operates at different levels, each requiring the involvement of specialist investment advisors, administrators, and financial intermediaries. Stakeholders include European and national governments investing alongside institutional debt and equity investors, microfinance institutions and local banks, who identify, qualify and manage local projects and various other parties involved on an investor and investee level. It becomes obvious, that these very complex structures, need to be managed by institutions and are supported by the advice of specialists to ensure the vehicle operates properly and investments lead to the anticipated returns and social outcomes. The results are, however, impressive. In the case of EFSE, the fund currently deploys around 1 billion Euros of capital and is involved with over 250 development projects in a sustainable model running since 2005 with consistent average returns to institutional investors, which clearly demonstrates the positive role, that institutions acting together, can play.

Another role that institutions can play in this market is that of organizations that represent investors or advisors interests as a whole, for example, trade organizations that lobby on behalf of an industry and offer support through representing common interests before governments and policy makers. Representing this view point in the panel was Francesco Briganti who is General Director of European Association of Paritarian Institutions (“AEIP”).

AEIP is a lobbyist organization, representing a group of institutional investors consisting of some 1200 social protection providers, including mainly pension funds, but also health care and disability funds. In general, these institutional investors are one of the most significant players in the capital markets as a whole, and would have a very positive impact, if such funds could connect with the types of social investment programs we are discussing.

Francesco has been directed by some of his members representing small regional pension funds who have an interest to invest into regional businesses and infrastructural projects. As a consequence, AEIP started discussions with local and regional governments to see how the money can be deployed in the area of social impact investing. However, as described above, this type of investment needs to be analyzed and carefully considered on a case-by-case basis, and generally bears a high level of risk.

Whilst the pension funds concerned see the long-term benefits of social investment, their first priority is to meet the financial obligations of their customers by delivering an appropriate level of returns at a reasonable overall risk level. In this process, the nature of the individual projects and also the overall attractiveness of the country play an important role.

An approach to address the AEIP members’ initiative and to meet the return needs of pension funds is the use of vehicles which pool long-term investments on a European level. This makes them more investable as they diversify potential risks. Respective regimes which address this kind of cross-border investment are the current focus of the European Union. Only recently the European Long-Term Investment Fund (“ELTIF”) regime introduced a new format of a collective investment vehicle targeting long-term investment in Europe.

Francesco also makes the point that, as well as specific vehicles such as the ELTIF, the impact of financial regulation and taxation in general has a significant role in creating a favorable environment to facilitate such products. Many, including Francesco, express skepticism as to how well these environmental factors are aligned with the EU’s overall objectives in this area.

There are, for example, directives such as Solvency II, which regulates insurance companies and, in particular, the amount of own capital they have to set aside to invest in certain types of investments. Although being a purely financial regulation, if not calibrated correctly, this regulation could dis-incentivize institutions to allocate capital to social impact products. Also, if we look in detail at the commentary on the previously mentioned ELTIF regime, we notice, that opinions remain divided as to whether this really offers anything new to institutions as an investment vehicle. On the surface, it certainly offers the opportunity to invest into local and European infrastructure and

businesses, thus to participate in the development of economy by benefiting from an appropriate risk and return profile. However, the complexity of the required structure, which implies a large and diversified investment portfolio, makes it difficult to comply with the respective rules. In addition, the introduction of a financial transaction tax does not help the marketplace overall.

What would really help promote such collective investment vehicles would be the introduction of a tax neutral status, similar to a Real Estate Investment Trust, which is not currently on the table. These are all topics on which trade organizations such as AEIP lobby on constantly, on behalf of their members.

To summarize, the successful growth of sustainable European long-term investments depends on aligning a set of complex factors at all levels in the market.

The role of institutions and advisors is key. If we look at the demand for capital, opportunities in the area of infrastructure and social impact investing appear to be abundant across Europe in various forms. Being able to combine public, private and institutional capital in generating a balance of both social and financial returns, should be part of the overall strategy to maximize the amount of resources that can be deployed, especially for larger scale projects. There are some shining examples of success today in the market. At the same time, we need favorable winds in terms of EU and local government policy.

Social and financial sectors working together to provide funding solutions to social housing in Scotland

Ian Marr

In 2014 Scotland asked many questions of itself in the context of a referendum on Independence. Central to the debate stimulated by these questions was our sense of Social Justice. It was clear that people across the political spectrum in Scotland shared a passionate commitment to Social Justice. This shared commitment provides the context in which investment in social infrastructure, using new instruments like the European Long-Term Investment Fund, are being considered in Scotland. The central concept framing debate about any investment in social infrastructure is that it must retain its central aim of engaging with, and positively influencing, social, economic and environmental conditions. It must improve the quality of life in a community for those people who live in that community.

The situation in Scotland

It is generally accepted in Scotland that there is a critical issue around the supply of Social Housing; this is an issue of creating new supply and the need to invest in upgrading existing supply where appropriate.

In terms of supply the current system is not performing adequately to meet the existing and growing demand for Social Housing which is created in part by the economic circumstances:

- Inadequate supply of private housing has led to increased pressure on the rental market, both private and social.
- In Scotland in 1999/2000 seventy five per cent of all families with dependent children who lived in rented accommodation lived in Social Housing. By the year 2012/13 this figure had dropped to less than 50%.
- Over the past 10 years rented housing has doubled but in the past 20 years those living in social rent fell from 40% to 25%.
- At 31st December 2014 there were 10,218 households in temporary accommodation, an increase of 3% compared to one year earlier. Of these 2,491 households included children.
- In the quarter 1st October – 31st December 2014 there were 7,858 applications for homeless assistance in Scotland.

- Increasingly prescribed access to benefits makes it more difficult for some citizens to access adequate resources to use either the private or social rented sector. In the quarter 1st October – 31st December 2014 16% of homeless applicants cited financial difficulties, debt or unemployment as a reason for their application.
- The number of social lets to homeless households has fallen from a peak of 5,600 in the July – September quarter of 2010 to just under 4,000 in the final quarter of 2014.
- Pressure on land availability leads to a high cost of land making it difficult to create Social Housing in a package which can allow for affordable rental levels.
- Pressure on Public Spending leads to limited levels of public subsidy to create Social Housing in partnership with Registered Social Landlords.
- The development of Registered Social Landlords in Scotland has led to a current situation where 97% of RSLs have less than 1,000 units which can create difficulties in achieving sustainability.
- The structures of funding for much recent Social Housing in Scotland has been on long-term mortgage type facilities with specific lenders, largely based on RPI +. Many of these loans are now not generating acceptable returns to lenders. This results in difficulty in further borrowing from that lender. If the RSL seeks new lending from that lender, or an alternative lender, then their existing lender requires a revaluation of their back book with a consequent adverse impact for the RSLs business model and medium to long-term sustainability.

Taken together these factors have created a system which is, at best, dysfunctional. It is naïve to believe that by pushing the existing dysfunctional system harder that it will work better. We need a new system.

A key feature of that new system must be an appropriate supply of cheap, or at least more affordable, money.

In demanding economic circumstances it is important that we do not allow those circumstance to dictate the kind of society and communities in which we live. Rather we must take hold of those circumstances with courage and imagination and use them in ways which create the kind of society and communities in which we want to live. Our economic structures and business models should be dictated by the nature of the communities in which we live and not the reverse. The pursuit of Social Justice should inform our investment in Social Infrastructure.

Housing tenure in Scotland is clearly changing and it is important that these changes are managed and developed in ways that proactively promote Social Justice. This provides a unique opportunity for Scotland to be a Pathfinder for a European Long-Term Investment Fund focussed on Social Housing, an opportunity that is being proactively pursued by potential investors and service providers in the community. This is actively supported by Scottish Government with Deputy First Minister John Swinney facilitating meetings between the Housing Minister, Margaret Burgess MSP, and representatives of INTEGRATE who are focused on practical thinking to inform long-term investment in social infrastructure across the EU. At the 2014 Rome Conference on “Investing in Long-Term Europe: Re-launching Fixed, Network and Social Infrastructure” John Swinney indicated that:

The Scottish Government greatly values the work of those who are at the leading edge of creating the conditions for a diverse and active social investment marketplace. We remain committed to working with partners to develop a joined up and coherent social investment policy in Scotland that recognises our values, seizes new funding opportunities and strengthens the third sector.

Finding solutions

Across organisations in Government, the Social Sector and the Financial Sector in Scotland there is an increased sense of common purpose to use the skills and insights available across these sectors to focus on making a real difference to real people in real communities. The purpose of an ELTIF in Social Housing in Scotland is to create a genuine, sustainable, high quality and cost effective impact on the provision of Social Housing as part of creating the conditions for greater Social Justice, Inclusion and Mobility.

To achieve this requires a substantial commitment from all concerned, not least in developing a much greater mutual understanding – and we will return to this.

Funding models

Over recent years a number of innovative funding models have evolved in Scotland which prepare the ground for an ELTIF investment, in particular:

- the Public Social Partnership (PSP) which relies on Philanthropic funding to initiate a new service in the community with specific measurable outcomes. If these outcomes are achieved then Statutory agencies are committed to mainstreaming the service going forward. The PSP continues to evolve to include elements of debt finance and patient capital.
- The Social Impact Investment Partnership (SIIP) evolved as a legal structure which sought to simplify the earlier Social Impact Bond and create greater community engagement in the investor community. In a SIIP the Delivery Partner, often from the Social Sector, designs and delivers a service in the community to address a particular social need with working capital provided from the Investment Partner/s. If the agreed outcomes are achieved then the Investors are repaid with interest at specified rates.
- The Social Impact Bond. This funding model has been used to fund at least one project exclusively in Scotland and a second UK wide Social Impact Bond has the facility to offer support in Scotland. Social Impact Bonds were initiated in the UK in 2010 and they are now used in a number of countries worldwide with 24 having been used nationally in the UK.

These developments in Social Investment, and Social Impact Investment, have not currently achieved a wide currency across Europe. The specialised nature of these investment structure has meant that the “Supply” side (the Investment Community), and the “Demand” Side (the Social Sector) have lacked the opportunity to develop mutual understanding of how they may separately and jointly engage with this investment opportunity. It is vital that we encourage the Supply and Demand sides to develop a more

effective mutual understanding in order to release the enormous potential of partnership working across these sectors which can support the development of Social Infrastructure which in turn changes lives.

Improving dialogue and understanding between stakeholders

To build on the positive developments in Scotland in terms of Social Investment we need to step back and create the opportunity for this mutual understanding to facilitate positive progress.

The Investment Community consistently indicated at the Rome Conference that they have significant liquid assets which they are keen to invest but that they lack investable projects. The Social Sector can demonstrate a consistent stream of projects which require investment. The Supply and Demand sides have, to date, been largely unable to meet in the middle to facilitate the flow of investment which would generate the much needed change in our communities and society.

Appropriate intermediation is required between Supply and Demand

The Supply side needs to invest sums on a scale which individual projects on the Demand side lack the capacity to absorb.

The Demand side needs the due diligence to be on a scale, which allows transaction costs to be minimised to make it cost effective. There is a disparity of scale between Supply and Demand along with an issue of intermediation costs.

The need is to find a route to scale: to allow the scale of Supply and Demand to be reconciled and this is generally perceived to be an issue of the Demand side accepting the need to adopt a singular route to scale which is generally about creating a size of organisation/operation which allows for economy of scale with efficiencies of back office function etc.

Herein lies the lack of mutual understanding between Supply and Demand

The Demand is to provide Social Infrastructure in a way that allows communities to function effectively to facilitate Social Justice within these communities but by its very nature this has to be achieved at a “community” level and a “community” scale. That is not the scale of the multi-national where cost efficiency is measured in the same way as when producing widgets on a production line. The nature of the Social Sectors business is different.

Generating scale by pooling public and private resources

What became clear in the Rome Conference was that the Social Sector needs a much better understanding of the needs of the Investment Sector. The Social Sector needs to understand the constraints, and expectations, of scale for the Investment Sector which to a degree are non-negotiable. Equally the Investment Sector needs to understand the

Social Sector where it has limited experience of investing: this lack of experience means that the Social Sector is a “box” into which investors are unfamiliar with placing their funds. The Social Sector “box” is very different from a more main stream investment “box”. It’s not that investment can’t be made in the Social Sector, simply that the nature of the Social Sector needs to be understood in terms of its particular goals of community capacity building and development meeting the human needs of individuals who often live in circumstances which require complex and inter-related support mechanisms.

To allow investment to flow in ways which are mutually beneficial to both the Social and Investment Sectors we need to create a “safe space” where both Investment and Social Sector professionals can engage constructively apart from seeking to negotiate a particular deal. A limited number of these type of deals are being done but the mutual understanding needs to be developed out with the heat of an individual deal. Governments, both national and European, should be encouraged to do more to support those involved to create that safe space to allow Supply and Demand to genuinely understand each other.

Supply side investors would benefit from a more detailed of knowledge of the dynamics of how communities work to support and develop individuals, even through demanding and challenging circumstances. What works for communities are things that operate at “community” scale: large impersonal organisations which put structure ahead of people in an understandable drive for efficiency simply don’t work at a community scale where Social Justice has proved elusive. There is ample evidence of this where large sums of money have been spent by large scale organisations in communities experiencing deprivation and little impact has been achieved in regenerating those communities.

An alternative route to the scale required by the Supply side must be found. Could this be by creating scale through the proliferation of multiple small scale locally based projects using a common model of delivery of service which is adapted to meet local circumstances? The Social Sector could develop an answer to this question. Could these multiple locally based projects be brought together in a syndicate investment which facilitates the scale necessary for the Investment Sector? The Investment Sector could develop an answer to this question. Could this be done in a way which allows for appropriate levels of due diligence to exercise fiduciary duty and keeps transaction costs within the range which allows the model to be viable? Together the Social and Investment Sectors could develop and answer to this question.

Achieving public value

On this latter point it is important to note the observation of the G8 taskforce report “Impact Investment: The Invisible Heart of the Markets” when it talks about a New Paradigm for Twenty First Century investment. This report indicates:

“The following chapter, The Third Dimension, focuses on perhaps the most important enabler of this new paradigm, impact measurement. Starting in the 1930’s, there was a concerted effort by Governments and the Private sector to develop better economic and business data, to enable policy makers, investors and corporate managers to better understand and manager performance. Today, there should be a similarly concerted effort to incorporate the measurement of social and environmental impact into the per-

formance reporting of governments, business and the charitable sector. This will be a challenge. There will be no perfect measures of impact. But that is no different from our measure of the economy and financial risk. As with them, the goal should be to develop measures that are good enough to be useful. The better we measure impact, the more capital will be invested in achieving it.”

The key words here are “good enough”. If we are to develop a new asset class for investment it must take seriously the expectations of investors but it must also take seriously the need of the sector into which it is investing: a compromise of “good enough” measures are going to be required and these can only be found and developed by the Investment and Social Sector taking the time necessary to understand the other to release the flow of capital that can change lives.

It should also be acknowledged that this type of investment is only likely to constitute a relatively modest part of the overall portfolio of investment for Institutional Investors. In that context it may be necessary to manage the investors return expectation downwards to facilitate the combination of transaction cost and viable provision of services in such a way that the goal of real difference to real people in real communities can be achieved.

An important factor in ensuring viable medium to long-term investment in Social Housing must also be that the housing stock created can be resilient to climate change. Much existing stock would require upgrading simply to allow Scottish Local Authorities to achieve their Climate Change Targets. For any new stock to be a viable investment it must generate added value by encapsulating in its design a move away from high carbon impact to a low carbon infrastructure and that should be incentivised in any funding structure which underlies the delivery of new and appropriate Social Housing in Scotland.

A European Long-Term Investment Fund for Social Housing

The European Long-Term Investment Fund offers a unique tool to facilitate the partnership working which can emerge from a more mature mutual understanding of the Investor and Social Sector.

In Scotland there is openness to Innovation in this respect evidenced by the work which has already been done in developing some of the new Social Investment models outlined above.

Further to this in 2013 the Local Authority Pension Fund Forum published “Local Authority Pension Funds: Investing for Growth”. This document considers how Pension Funds can invest to derive wider economic benefit including links to place through things like Social Housing. The Investing 4 Growth initiative was launched in 2013 by five local government pension funds. These funds are together seeking investments that have an economic impact as well as positive social and environmental outcomes in the UK.

The Pensions Infrastructure Platform (PIP) was set up in 2012 with ten pension funds, including the Scotlands largest local government Pension Fund in Strathclyde. PIP aims to be a vehicle for pension funds to invest in UK infrastructure assets, for long-

term returns. Strathclyde Pension Fund said PIP provides ‘a very clear example of how the investment made by our members in their own futures also helps to support jobs, investment and the wider economy’. Is it enough to provide good pensions if the area where most pension beneficiaries live does not benefit from their investments? There is a strong case, in terms of Social Justice, that part of the portfolio of local government Pension Funds should be used for Social Investment in tools like a European Long-Term Investment Fund for Social Housing which allows the quality of life to be significantly improved for those people in the local community who pay in to the Pension Fund and who, in due course will draw on those funds in the context of living in that community which has been enhanced by the investment of the same funds.

Long-term purpose could also be seen to be about mitigating costs and risks to those local authorities.

Owen Thorne of the Merseyside Pension Fund noted: “Over the long-term you can help the local economy, through supporting growth of local council tax receipts and mitigating other local welfare or social housing costs. This is a more holistic view of fiduciary duty than the narrow perspective focused only on returns.”

There is a unique, and possibly time limited, opportunity for releasing the power of an ELTIF in Social Housing in Scotland.

One of the great strengths of focussing an ELTIF on Social Housing is specifically that Social Housing provides a clear and tangible return on the investment in the physical structures of the homes and these homes provide the focus for services where additional investment in health and social care can be easily “wrapped around” the homes for those people who live there. These services may relate to a wide range of health issues; disability, mental health, life limiting conditions, substance dependency issues etc. They may relate to adjustment to settled tenancies following a period of homelessness.

They may relate to adjustment following release from custodial sentences. In fact the ELTIF could combine with one or more of the other Social Investment tools outlined at the beginning of this chapter to support these “wrap around” services or they may simply be folded in to the ELTIF. In either event there is a strong case for including the personal support aspects in to the total investment; failure to do so would inevitably result in higher rent arrears, evictions, voids and higher than normal repair and maintenance costs to the housing management all of which detracts from the efficiency of the investment and has the potential to impact on investor return.

In summary

- Scotland provides a supportive environment for investment in Social Infrastructure
- Scotland provides an environment where alternative Social Investment models have been emerging in recent years
- Housing tenure in Scotland is changing and there is a need ensure that the development of Social Housing is adequately supported in this changing situation as a key aspect of ensuring that Social Justice is rooted in local communities

- The European Long-Term Investment Fund mechanism, possibly supported by the other Social Investment models available in Scotland, offers a unique opportunity to invest in the Social Infrastructure of Scotland
- To facilitate ELTIF investment of this type the Investment and Social Sector need to develop better mutual understanding to facilitate effective partnership working
- By focussing an ELTIF in Scotland on Social Housing there is a singular opportunity to fold in to that investment additional support services for those people living in the Social Housing.

Investing in responsible and sustainable health infrastructure in Hungary

Miklós Szócska

I consider myself a public reformer. But for four years I was thinking about health reforms from an investment perspective. Where should we invest for the efficiency and sustainability of the health care system and where should we disinvest, not to waste money and where invest to gain more healthy life years. So, your logic – in a public sense – is not alien to me but I am a public sector person.

Health reform

To understand where we should invest, you should know something about the health reform cycle in Hungary. When a new administration comes into office they have new ideas, then they intervene into the system, they do this fast because the previous one had not enough time to solve problems. So with a very different new administration they have to get into the system fast to change things. I am sure that this is a similar experience for others working in public policy elsewhere in Europe. In Hungary that led to an average life expectancy for someone in my chair as a Minister of State for Health of only 20 months. Imagine the health care reform you can do in 20 months. I was in that chair for 48 months so managed to do several things. And one of the reasons I could stay there for that long was that I did it with consultation.

Consultation

Before we intervened into the system I toured the country three times. First, I talked to each and every mayor, each hospital, each county council about their hospitals and communities. Second we had to agree on the directions for reform. In the third tour we agreed about what their role in the new Hungarian health system would be. We used evidence and then we did radical things. In public health we introduced taxation. We taxed Coca Cola and Chips so if you live an unhealthy life with sugar and salt then you pay a little bit more for your risks. And from that taxation I raised the salaries of doctors and nurses to try and keep them in Hungary because the migration of medical professionals is a huge issue. We also introduced our own NHS. We took control of all the hospitals into state hands from the municipalities because capacity was mushroom-

ing. In Budapest, this led to building prestige hospitals on two-sides of the river because there were no central capacity controls. So we took over all the hospitals and I saw all the 48 contracts those hospitals made – all the two million bank transfers they made. Imagine the power of that stuff! So, we did a lot of work and this is not an approach that was traditional in Hungary for public policy making. The news about taxing coco cola was even covered in the Boston Globe.

Capacity mapping

And now we zoom into these maps. Before we dived into the health care system we did some capacity mapping that could show us:

- Where do patients go?
- Where do they seek care?
- Where do they receive care?

We even modeled access times and where to put various services. And then we just regionalised the care and then the interregional migration became clearer. So, people could find care in their communities. We also looked at patient flows. We network analysed patient flows between hospitals. What you see here is the Hungarian cancer care network and you see white patches in the South-East side of the care network. We also looked into, for example, the Budapest cancer care network and why patients move between the various dots. Is it a lack of therapy? Is it a lack of capacity? Is it a lack of knowledge? Because there is good migration and bad migration. For example this migration is good because this institution has radiotherapy. But it is so damn expensive. If you do want two radiotherapy centres on both sides of the river then you institutionalise their relationship and this is what we did. And there are other movements where people seeking hospice care. And a hospice should be in the community. So invest in good local hospices and don't make people flow around with an incurable disease.

Identifying where to invest and disinvest

So, these types of charts were the basis of where to invest and where to disinvest. And you know, just putting these crazy movements right in 18 months we increased liver metastases operations by 50%. Before that, these people did not get relevant therapies. You do not operate on a metastases at those many places in a single city or in the country. It was operated on at eight places in the country. So, in 18 months of setting these complex patient pathways right increased liver metastases operations by 100%. So, we found the missing 50%. These patients are very costly. A single therapy is tens of thousands and sometimes 100.000 dollars. So, you do not want these people to wander around having those expensive therapies in a small city hospital. Instead, you provide this treatment in specialist centres. Why? Because this does not happen every day but 1-2 times in your life. So, we used innovative evidence to change the settings within the health care system.

The need for e-Health prevention, prediction and participation infrastructure

Migration of the health labour force is a major issue so we need to think of ways to use them efficiently. e-Health is another area where there is an ecosystem lacking. To give an example, in Hungary all ambulances are equipped with tele-ECG machines. And in a cardiac centre they have are waiting to rush cardiac patients to these centres. But there is no financing system, no payment system, no research generation for that ecosystem to happen. But we have scarcity in cardiologists. On a European level one million people will be missing from the health labour force by 2020. So, you invest in efficient technologists and efficient patient pathways if you want to set it right. We know it is now possible to trace our jogging habits and our health status and individuals can send public health warnings. You can assess lifestyles. Sensors are there in your mobile devices and you know how to use it. You know how to use it and even the grandchildren of sick older people know how to use smartphones and similar technology but there is no ecosystem behind what is available in the market. So, one of the big investments should be in e-Health prevention, prediction and participation infrastructure. With mobile devices one part of the ecosystem is there and there is a culture to use it for other purpose

Hospital indebtedness network analysis

Now I show you some management control slides. This a hospital indebtedness network analysis. The blue are various hospitals and the yellow are various procurers. This was produced at the time when the state recovered the hospitals from the various municipalities. The larger blue dots show the hospitals with larger debt and the larger yellow dots shows the larger the amount of unpaid money owed to them, the larger the money they use for financing hospitals. You can see that three of them were financing the hospital indebtedness live banks. Yes, there was a banking operation behind it that is illegal in the Hungarian public sector. So, we saved 50% from paying those procurers. We told them that this is illegal. What if I fine you 50%. So, on this chart we recognised that there had been the formation of a monopoly market. Those that owed larger money to fewer companies demonstrated this monopoly market. And yet, these hospitals were in the hands of over 100 municipalities and still there was a monopoly. So, from the network analysis we could identify where intervention was needed. This chart helped understand market formation. For example, we introduced national joint procurement of energy. On gas alone we saved 20% and on electricity we saved 15%. This shows that using new management control technology and data mapping in the public sector could save taxpayers money and liberate resources to invest somewhere else where there can be life years saved. Just imagine, health care is an energy-intensive sector. So, if with a procurement system you can save 20%, what can you do with a targeted energy efficiency investment? And structural funds are so slow and the scale of money that is needed to improve efficiency in the health care sector is just unimaginable.

Citizen learning – We have to invest in citizen learning because we have to explain to them that you did not demand the prestige hospitals but you demand an efficient community setting. I closed 14 hospitals: the acute care they provided and I gave them

local community centres with patient services instead. We need to help Prime Ministers, Ministers of Finance and citizens to learn where to achieve efficiencies.

Preventive investments – Public expenditure on health care will grow and if you do not invest in efficiency now then there will be social sustainability problems 15-20 years from now. So, there need to be preventive investments in efficiency.

Pharmaceuticals – Some of them are public utility products, so we should purchase innovation and not keep paying the marketing engine of big pharma.

A regional reflection on Long-Term investment opportunities

Sir Albert Bore

The main principle behind the EU Investment Package, to boost investor confidence, is to be welcomed. However, what impact will the EU's recently announced €21 billion investment have? The EU investment is not new or additional money, indeed some £6 billion of this is being taken from the current Connecting Europe Facility and Horizon 2020 programmes. Is the estimated multiplier effect of 15 to deliver €315bn (£249bn) for strategic infrastructure projects over three years realistic?

Jean-Claude Juncker himself has said that "it would be a pipedream to think that the Commission alone can ensure the total success" of the investment package. This was in reference to the engagement of national governments and the private sector, but we should not forget the local level, particularly the role of cities in this.

Cities are already innovating to secure investment and to create jobs and growth, despite the constraints of centralisation evident in particular in the United Kingdom. If the Investment Package is to truly succeed then it needs to link up with those innovations and support the growth in our capacity to act at a local level.

The local level: the example of Birmingham

We also have to consider whether the cities have the right tools and powers to act. From the perspective of the local level, how will local and regional authorities be able to benefit from the EU Investment Package? How will the projects put forward by national governments connect with the local level, and crucially with Europe's major cities, the main engines of growth?

The opportunities and the need for investment in our cities are certainly there and I'd like to share with you just a few local initiatives, both physical and social, to illustrate how my city is taking forward the growth challenge.

In Birmingham, I recently unveiled the city's 20-year vision for improving transport across the city – effective and efficient transportation being one of the major catalysts for growth; this includes a detailed programme of short-term schemes.

Birmingham is also focussing investment activity on six economic zones defined by both geography and economic sector. These are:

- An advanced manufacturing zone
- A city centre enterprise zone

- An environmental enterprise district
- A life sciences campus
- A food hub
- And the ITEC park focussing on ICT

We have also taken steps to tackle youth unemployment in Birmingham which are, of course, examples of social investment:

We established the Birmingham Jobs Fund in 2013 which has supported well over 1,000 young people into work or training. The Birmingham Jobs Fund re-directs £2m (€2.5m) of council funding which is pooled with grants from the National Apprenticeship Service, Talent Match Big Lottery money as well as the UK Government's Wage Incentive Scheme – regrettably the UK Government announced this summer that it would be scrapping this last scheme. We have therefore had to modify the Birmingham Jobs Fund by varying the level of incentives available to employers, to ensure that we maintain our target of delivering a further 1,500 of our young people into jobs and apprenticeship opportunities.

I have also launched the Birmingham Youth Promise which will be fully operational during 2015. This will provide guaranteed employment, education, training, apprenticeship or experience of work within four months of leaving a job, education or training.

Cities such as Birmingham also have strong and sophisticated relationships with communities and the third sector which should be tapped into to ensure that investment opportunities are fully maximised. Strengthening the social infrastructure is highlighted as a significant feature in this new package and in order to do this cities need to move on from the so called 'triple helix' partnerships with business and academia to furthering 'quadruple helix' initiatives that embed the voice of people and communities through 3rd sector organisations in the growth agenda.

In December 2013 I launched a Social Enterprise Quarter in the Digbeth area of Birmingham where over 50 social enterprises are based. Birmingham City Council has pledged to support the development of a thriving social enterprise sector, seeing it as an important part of a healthy mixed local economy. This has been included in our new European Structural and Investment Funds Growth Strategy as it is seen as a key route for helping to create jobs and growth, alongside other sectors, and also brings another dynamic to the mix – being rooted in the local community.

These are all investment opportunities in a city whose transport infrastructure has been woefully underinvested in over the past 25 years, and whose unemployment rate is nearly twice the national rate of 5.8% and the second highest of all the UK's major cities. And this is a city in which 67% of our total income comes from Central UK government and which is being slashed significantly year on year.

There is a clear message here about the level of local discretion with regards to local reserves. The UK economy is one of the most centralist in Europe. The imperative for investment at the local level in our major cities, such as Birmingham, is clear. So how will such a plan for long-term investment funds link and add value to local growth strategies and investments?

Linking the Investment Package to local strategies

The Investment Package also makes reference to accessing EU resources. This is crucial as accessing EIB monies, and then passing this on to SMEs through Financial Engineering Instruments is an incredibly complex landscape and we would, for instance call for rules around state aid to be simplified so EIB resources can be tapped into quickly and effectively.

The local level can play a critical role in the delivery of a European Long-Term Investment Fund for Innovative Social Infrastructure. We are already working with the Local Enterprise Partnerships in the West Midlands to develop a £125m (€157m) EU JER-EMIE fund to stimulate the growth and competitiveness of our SMEs.

However, the lack of tools and by that I mean powers and funding, are a straight-jacket preventing cities taking leadership for the very measures this new Investment Package aims to adopt. Remember cities are already doing much of this, but could do more. I mentioned my bold plans for transport, youth unemployment and enterprise to name a few. With the right investment stimulus these initiatives could have a long-lasting and sustainable impact. Can initiatives like the EU Investment Package ride the wave and capitalise on local commitment?

Cities, in particular, are on the frontline of dealing with unemployment, an ageing population, sustainable development, and having to take bold decisions to re-structure and grow their economies. Cities also have the knowledge, partnerships, and investment-ready opportunities to ensure that such financing can have a quick yet lasting impact.

The radical devolution of powers and finances - or in the case of the European Long-Term Investment Funds, the access to finance - must be part of the response to ensure sustainable economic growth in Europe.

The need for financial innovation

Enhancing the policy framework for investment in Europe's infrastructure

Carole Biau

Introduction

The downturn in investment within advanced economies from the onset of the global crisis has been severe. As a result, many countries have large investment gaps. In particular, investment in the EU has dropped by more than EUR 430 billion from a 2007 peak. This is a major concern as prospective needs for investment, notably global investment in infrastructure, are huge. The OECD has estimated that the total requirement for global infrastructure investment by 2030 for transport, electricity generation, transmission and distribution, water and telecommunications is approximately USD 71 trillion. Added to this, achieving a low-carbon energy sector globally will require a further cumulative investment of USD 18 trillion by 2035, one quarter of which in China alone.

Current public and private spending fall far short of filling these infrastructure needs. On the public side, balance sheets are overstretched, limiting the ability for governments to finance major infrastructure projects. From 1980 to 2005, the OECD has estimated a fall of the average ratio of public fixed investments to GDP from above 4% to about 3%. On the private side the situation is no better: over 2010-2012 for instance, an average of 8% only of FDI inflows received by OECD countries was ending in infrastructure sectors as opposed to more than 10% in 2007-2009. These trends need to be reversed and the opportunities are important. This urgency is fully recognised by the EU Investment Plan, which is designed as “an investment offensive to get Europe growing again” and aims to unlock public and private investments in the real economy of at least EUR 315 billion over 2015-2017.

Renewed investment, including in infrastructure, in part depends on effectively functioning credit channels. Yet traditional sources of credit such as banks remain constrained. As highlighted by the work of the OECD Financial Markets and Pension Funds Committee, the financing gap could be reduced if institutional investors (such as pension funds, insurance companies and mutual funds) were to increase their role in infrastructure markets. Investments in real productive assets, such as infrastructure, could potentially provide the type of long-term, inflation-protected returns that these investors require.

However, availability of finance is not the dominant problem in the infrastructure investment equation. Company data show that retained earnings, which traditionally make for the largest share of investment financing – even in infrastructure – are held back by investors who use them for buybacks and dividends (OECD, 2015a forthcoming). Investors seem to avoid long-term commitments in infrastructure markets for questions of project

bankability but also in response to uncertainty and broader structural features of these markets. This was clearly expressed by institutional investors participating in the 2014 International Conference of the Long-Term Investors Club, which the OECD co-organised last December in Rome. Risk mitigation instruments can help but are not enough; there is a need to focus on specific obstacles which hamper project delivery, including the framework for investment in host countries, the resolution of market imperfections in network industries, and government commitment for long-term investment in infrastructure. For this reason, OECD work on investment in infrastructure addresses not only obstacles to the supply of finance for infrastructure projects, but also – through the OECD Policy Framework for Investment (PFI) – the dominant bottlenecks in the enabling environment. That is, given an availability of private capital, what are the policy steps to take to channel available finance into long-term investment destinations.

The EU Investment Plan proposes three strands of work which are highly relevant in this context: (i) mobilising investment finance without creating public debt; (ii) supporting projects and investments in key areas such as infrastructure; and (iii) removing sector specific and other financial barriers to investment, including by creating an “investment friendly environment”. On this third pillar, the Plan points to persisting administrative burdens and regulatory complexity for investors, and to the need for a clear, predictable and stable regulatory framework, including efficient application of public procurement rules at all levels. The Plan further calls for determined efforts to remove regulatory bottlenecks, integrate infrastructure networks and implement and develop the existing rules at national, regional and European levels. The OECD PFI and related instruments can make a particularly strong contribution on this third pillar of the Plan, by tackling inter-related elements of infrastructure investment policy and market structure.

In particular, in order for infrastructure investment to present a realistic and attractive value proposition for investors, one must consider three core factors of the investment equation: (i) private access to infrastructure markets, as a precondition for entry; (ii) level and consistency of rates of return for infrastructure investors; and (iii) appropriability of those returns over long-term investment horizons and given high upfront capital costs. These three elements are briefly addressed below, drawing on OECD experience with a wide range of member as well as non-member governments.

Private access to infrastructure markets

Greater investment policy openness can require rationalising statutory barriers to private investment, including foreign investment. The OECD FDI Regulatory Restrictiveness Index shows that restrictions to foreign direct investment (FDI), together with other operational restrictions, are often in place in infrastructure sectors – either to shield domestic investors from external competition, and/or to keep control over strategic assets and services. Preference margins in public procurement legislation are also commonly used to favour domestic bidders in infrastructure contracts. While it is important that governments preserve the right to regulate in this domain, the costs and benefits of such measures must be carefully assessed. Unless adequate capacity exists among prospective domestic investors and bidders, FDI restrictions and preference schemes may compromise

on infrastructure delivery and quality without necessarily reaching the intended development objectives. Such restrictions may also send mixed signals to investors regarding the government's stance on private sector participation in infrastructure. In addition to efforts at national level, mega treaties such as the Transatlantic Trade and Investment Partnership (TTIP, under negotiation between the United States and the Europe Union at the time of writing) could help derestrict several services sectors and network industries.

For reasons of 'natural monopoly' (especially scale and network economies), the majority of infrastructure markets also present cases of market power. Many infrastructure markets have therefore traditionally been monopolistic in Europe and elsewhere – but the result has not always been efficiency-enhancing. Competition authorities as well as infrastructure sector regulators have a key role to play in this regard, to ensure that all investors operate on an equal footing and that there is a reasonable value proposition for potential investors. Policy advocacy by competition authorities can affect the extent of market dominance in infrastructure markets, and (especially in areas where public provision has historically been ineffective or fiscally burdensome) can inform structural separation in view of opening market segments to private participation. Upstream of infrastructure markets, competition authorities can also help identify and counter cases of bid-rigging and collusion in project procurement. To play these roles effectively, in particular when they must challenge vested interests in utility markets, competition authorities require adequate political support and independence.

The efficiency and corporate governance of state-owned operators in infrastructure networks is also a crucial consideration for private investors, whether they are considering competing with the operator, partnering with it (through a PPP or a power purchase agreement for instance), or taking it over after divestiture. SOEs have considerable economic weight in infrastructure sectors worldwide, and Europe is no exception. SOEs account for 2.5% of national employment on average across OECD countries, and SOE employment share exceeds 6% in Norway, France and Slovenia. Moreover, 50% of SOEs from OECD countries by value operate in infrastructure network industries (electricity and gas, telecommunications, transportation and other utilities). SOEs do not always face the same business conditions and cost structures as private investors: in many cases they benefit from preferential access to finance in the domestic financial market, preferential land allocation, low utility prices, or easier licensing processes. Furthermore, because of a lack of commercial incentives, many SOEs are inefficiently operated. This can result in poor infrastructure maintenance, service quality and network management – which can also deter private participation. The OECD Guidelines for the Corporate Governance of SOEs highlight how high standards of corporate governance for SOEs can help enhance their efficiency, improve public finances, and make for more constructive collaboration between public and private actors.

Rates of return

In addition and aside from their basic market structure, infrastructure sectors are often regulated in their prices and operations. Such regulation is important to strike the right mix of taxes, tariffs and transfers (the "3 T's" identified by the OECD's Regulatory Policy Committee) that can safeguard end-user affordability while maintaining realistic prospects for

cost-recovery for private as well as public investors. But because of the strategic nature of infrastructure services, there is a risk that political influences distort regulatory functions. For instance, even where there might be a 'willingness-to-pay' for a given infrastructure service on the part of consumers, political resistance to raising utility charges can remain high (OECD, 2012). For such reasons, the independence of infrastructure regulators, together with sufficient scope of action and accountability, can help meet social objectives while reassuring investors regarding the consistency of future revenue streams. Indeed, evidence from 13 OECD countries over 1995-2006 suggests that on average, a one-step change in either incentive pricing or independence of infrastructure regulators can induce a 5.3% increase in the ratio of investment to gross value added in a given infrastructure sector (Sutherland et al., 2011). The EU Investment Plan points out that closing gaps in the regulatory environment of the Single Market could have cumulative benefits as great as EUR 1 467 billion per year.

Appropriability of returns

Participants at the 2014 International Conference of the Long-Term Investors Club also repeatedly emphasised the need for government commitment to LTI in infrastructure. If government commitment changes across administrations, it can expose infrastructure projects to various risks, including direct expropriation (through re-nationalisation for instance) and indirect expropriation (for instance if infrastructure tariffs or incentives change in such a way as to significantly reduce cost-recovery prospects, or the value of the underlying asset, for investors). Literature on the 'obsolescing bargain' between private and public partners has indeed often treated the case of infrastructure networks (Kindleberger, 1969; Post and Murillo, 2014). According to the 2013 MIGA-Economic Intelligence Unit (EIU) Political Risk Survey, adverse regulatory change is the political risk of most concern for 58% of investors, followed by breach of contract (48%). Of those investors having experienced a breach of contract in 2013, 19% were engaged in electricity and power, 16% in telecommunications, 12% in transport, and 6% in water and sanitation (WBG, 2013).

OECD experience with member and non-member countries shows that governments have many tools at their disposal for allaying investor fears over the appropriability of returns, and for better signalling their commitment to long-term investment partnerships. The institutional and legal environment for investment, including as pertains to contract enforcement and rule of law, plays an important role, and can be complemented by an explicit legal framework for public-private partnerships.

Alongside, the long time-lines of infrastructure projects and the unpredictable nature of many of the risks involved make it crucial to provide for effective renegotiation of infrastructure contracts. The new EU directive on the award of concession contracts (2014, to be applied at national level as of 2016) strikes a good balance between contract flexibility and government interests, by defining what constitutes a substantial modification to contractual terms (requiring a new bidding round) and what can simply be adjusted for through renegotiating the contract (any effects bearing on less than 10% of the price of the initial contract). Such provisions create a 'safe harbour' for contract resilience over time, while protecting governments from investor opportunism and helping ensure that value-for-money and competitiveness are retained as priorities (EC, 2014).

Policy action at national and regional levels

Simultaneously addressing all the policy elements that factor into these three dimensions – market access, level and consistency, and appropriability of investor returns – is a tall order for policymakers. The relevant reforms cut across a wide range of policy fields. The good news is that for the many variables in this equation, the OECD has an array of corresponding policy bodies. Its cross-cutting nature is a powerful instrument for coherence in policy reform, which it can bring to member and non-member countries alike.

This is the spirit of the OECD's Policy Framework for Investment (PFI) which provides an integrated framework to improve policies for both foreign and domestic investment, with linkages to human capital, tax, competition, infrastructure, responsible business conduct, and other issues which can enhance the development returns of investment. The PFI also has sector-specific applications, with tools such as the OECD Policy Guidance for Investment in Clean Energy Infrastructure, which can help implement the sustainable development objectives of the EU Investment Plan.

Following the success of PFI applications at national level, this tool is also being applied at regional level in several contexts. This can be of particular interest to European governments as well as prospective investors. Regional projects enable cost efficiency and economies of scale to be reached, and improve the business case for greater structural separation of networks. They also fulfil an essential role for connectivity and trade. The EU investment package is partly aimed at improving cross-border infrastructure, for instance by investing in the France-Spain electricity interconnection. In line with such objectives, the EU Investment Plan calls for reinforcing the European Energy Union, as well as implementing the Fourth Railway Package, the Blue Belt package on maritime transport and the European Single Sky objectives.

It is clear that beyond financing, making cross-border infrastructure projects a success will require regulatory reform at a regional scale, so as to reach consistent and effective approaches across the elements raised earlier in this chapter.

The OECD's 2014 EU Economic Survey indeed points to the need for more integrated market regulation in relevant infrastructure sectors, for instance in energy where rules for cross-border trade are still highly fragmented. The existence of country-specific technical requirements can also reduce the potential benefits of vertical separation in the European rail sector. In addition, local content requirements (LCR) across neighbouring countries can prevent economies of scale; OECD analysis shows that recent increases in LCRs in the renewable energy sector have led to sub-optimal investment flows throughout the value chain.

Conclusion

Over the past decade, on the one hand, the public sector has been less committed to infrastructure development: in Europe, average public investment in infrastructure is thus estimated to have fallen from about 5% to 2.5% of GDP between the 1970's and the 2000's (Inderst, 2013). On the other hand, the private sector has been unable or unwilling to take over from governments and make up for the reduction in availability

of public finance. OECD analysis suggests that, beyond important barriers to financial intermediation, crucial reforms need to be brought on the other side of the investment equation – the enabling environment in host countries.

Lack of regulatory consistency and stability, as well as limited access to infrastructure markets, continue to make national and cross-border infrastructure projects relatively unattractive for many private investors. Using the recently updated OECD Policy Framework for Investment¹ as well as related tools and reform indicators², the OECD is keen to work further with Europe's institutional investors and policymakers in identifying, measuring and improving these inter-related policy settings, so as to better deliver on the ambitious objectives of the EU Investment Plan.

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- 1 The PFI has just been updated by a task force of OECD and partner countries, notably to better reflect the need to promote long-term investment in infrastructure and to draw on experiences gathered from its application in over 30 countries.
- 2 In the context of the PFI update, the OECD developed a flagship paper on "Fostering infrastructure investment: Lessons learned from OECD investment policy reviews". With this paper as a starting point, the G20 has requested the OECD to develop, together with the World Bank and other MDBs, indicators on the enabling environment for infrastructure investment. Such indicators can help governments implement and monitor relevant policy reforms to further mobilise infrastructure investment.

The perspectives for private finance initiative (PFI) and public-private partnerships (PPP) in the EU

Nicky Edwards

The European Commission in 2011 found 'preliminary estimates' for infrastructure investment needs up to 2020 in the range of €1.5-2tn, or an annual amount of €150-200bn on average.

Building the infrastructure that will make Europe globally competitive is a massive undertaking. Neither the public nor private sector alone has the capacity to deliver what is needed.

Only by working in partnership across the whole of the EU can a challenge on this scale be met.

Energy security, transport networks and world-class digital connectivity as well as housing, schools and hospitals and the indispensable building blocks of social and economic well-being. Europe's financial services sector can play its role in helping to deliver those benefits. Consumers rely on long-term savings, loans, investments and insurance products to meet their financial needs over the course of their life, whether it is buying a home or meeting the costs of retirement. Investing in long-term infrastructure projects can match consumers' long-term financial needs.

There is no shortage of money to finance infrastructure, but there are obstacles in the way of the efficient allocation of capital to infrastructure projects. There is also competition for this money in the global economy which the EU must work to attract. It is difficult for projects to get funding unless the providers of finance have certainty about how they will get paid. The EU has rightly focused on both the importance of a Single Market for capital and a comprehensive Infrastructure Plan as essential for Europe's competitiveness.

The allocation of risk in infrastructure projects is crucial to their success and neither the public nor the private sector on their own can manage these risks. It is through the partnership between public and private sectors that risks can be properly allocated. What is required is that the public sector balance sheet should stand behind the risks that it is proper for it to bear, not that fiscally challenged governments alone should finance all the infrastructure which Europe needs.

The European Commission's Investment Plan acknowledges the need to improve access to financing for infrastructure and the role that capital markets can play to address the intermediation gap between the supply and demand for long-term financing. Where

markets are deep, liquid and well-regulated, market-based financing can play a role in narrowing investment gaps by providing a viable alternative to bank financing. Capital markets can facilitate the allocation of finance for infrastructure that enables economic productivity and employment growth.

The Commission's Investment Plan sets out the steps to boost investment, stimulate economic growth and create jobs. The proposals to establish a credible project pipeline, coupled with an assistance programme to channel investments where they are most needed and to work on a roadmap to make Europe more attractive for investment and remove regulatory bottlenecks is welcome.

Private sector investors are looking for safe, long-term investments that will generate a worthwhile return on capital. Governments at local, national and EU levels have infrastructure ambitions which are greater than the public purse can fulfil. But it is not the case that the public sector can simply promulgate a list of infrastructure projects and wait for the private sector money to pour in. The crucial intersection of the public and private sector interest in infrastructure financing is in the effective allocation and pricing of risk.

Infrastructure projects face considerable future risks and uncertainties. The financing of infrastructure projects is subject to selection risk, planning risk, procurement and contract design risk, construction risk, asset operation and longevity risk, and political risk. Of these, planning and political risks are most notably beyond the control of the private sector and political risk is predominant. It is only when the public and private sector work in partnership that these risks can be properly managed in a way that unlocks the finance necessary for infrastructure construction and renewal.

The financing of infrastructure projects can be improved through effective allocation of risk between the public and private sectors. It is important to consider where infrastructure projects sits on the public sector balance sheet. By working in partnership, the public and private sectors can deliver a pipeline of strategically significant infrastructure projects that enable the creation of jobs and growth in the broader economy. Only governments can give the long-term certainty throughout the life of a project that makes political and planning risk acceptable to investors. By the transparency, predictability and certainty of planning, procurement and policymaking, governments can fulfil the public sector's ambitions for infrastructure in partnership with private finance. Infrastructure is not an end in itself. It only serves the public good if it enables competitiveness that deliver jobs and growth. There is no appetite to build roads to nowhere.

The UK has long experience of Public Private Partnerships (PPP), with the UK Government's PF2 being an evolution of the PPP model.

The worldwide construction market is worth \$7.5 trillion a year and that dwarfs the capacity of individual states or even groups of states to fund. PPPs are now global, with over a hundred countries looking to introduce them and forty countries now having some form of PPP unit. This is not just a question of capital to deliver projects, there is also a very important element of human capital – of expertise and know-how – that goes beyond the engineers who deliver infrastructure projects or even expertise from the financial services sector which finances them. There is a whole eco-system of professional

support that enables these deals to be done and projects to be built. In order for them to be successful, PPPs need a clear structure that balances the risks taken by the private sector with the appropriate rewards and also gives clarity about what the risks are from the outset and how they'll be apportioned.

PF2 continues to draw on private sector experience, but also builds on the expertise of the public sector as an enabler and a commissioner. There is a focus on asset design and construction, with responsibility for maintenance and renewal in a single contract to bind in the investors over the life of a contract. There is a recognition that models need to become more flexible and to provide greater discretion over what is included in a project. It is important that all parties are incentivised properly. One of the inhibitions to finance in this area is that there can be a short-termism in how success is measured and how rewards are attributed. So proper incentives and proper measurement of success are important.

In terms of long-term and cross-border infrastructure the Channel Tunnel high-speed rail link is an example of a cross-border project that was complex and large-scale but delivered on-time and on-budget. One of the important factors in that success was the role of government guarantees in mitigating the market risk for private investors. Governments, whether individual Member States or collectively, have a crucial role in selecting suitable projects, in defining the objectives from the outset, enabling the proper structures to be put in place before beginning procurement and to negotiate the optimal risk transfer.

The private sector brings to this a commitment to serve their investors and customers by optimising the return on investment. We should never lose sight of the customer, the individual whose pension and personal savings is tied up in the success of these long-term plays to meet their long-term needs, for example for an income in retirement that may be many years ahead and last for decades.

The European Union faces a competitiveness challenge in the global economy. The successful renewal of infrastructure, envisaged in the Infrastructure Plan and the creation of a Capital Markets Union would enable the EU to rise to that competitiveness challenge, creating the jobs and growth that its 28 Member States and 500 million people need. Both the Infrastructure Plan and a Single Market for capital will only be achieved if the public and private sectors across the whole EU are able to work together, constructively, in partnership.

The role of asset managers and the case of the ELTIF Regulation

Agathi Pafili, Bernard Delbecque

Long-term social and infrastructure investments in Europe offer great potential opportunities for both investors and those seeking positive social outcomes. This is, however, a complex market which crosses borders as well as social boundaries. It is a market which combines public and private capital sources, and whose success is measured both in social and financial outcomes. This paper is based on a panel discussion held at a conference in Rome, “Investing in Long-Term Europe: Re-launching fixed, network and social infrastructure”.

It investigates the roles, that different institutions, intermediaries and advisors can play in connecting the supply of capital looking to invest long-term for both financial and social impact returns, and the demand for capital from a wide range of social and physical infrastructure projects within the EU.

There are some obvious inherent challenges, when looking at the structure and dynamics of this market. There is, for example, the big challenge to establish real connectivity between the supply of institutional and public money and the broad range of projects existing in the European market, operating on many different levels, where the combination of financial and social outcomes might not be obvious. How are potential projects identified and selected? How can both social and financial goals be aligned? What is the most effective way to use public funding, if available? Can projects be aggregated into larger more “investable” vehicles, which better diversify risk for investors? What types of governance and oversight models are most appropriate? Can government policy have a positive effect on this market by, for instance, providing incentives in areas such as tax and financial regulation?

At the root of this debate, there is the fundamental question, as to what extent can public expenditure and private social investment programs (philanthropy) be combined effectively in appropriate vehicles, potentially alongside financial investors seeking both an exposure to impact investing, as well as meeting economic return objectives.

The degree, to which this can be achieved invariable, depends on the nature, size and compatibility of the projects, which make up the investment program. One obvious role for institutions is to somehow act as “market makers” as well as investors. They can do this at various levels by providing not only the capital, but also the expertise in identifying and structuring deal flow and packaging projects into the appropriate vehicle. The

overall objective here is to maximize the leverage effect of philanthropic capital, which seeks only a social return, to efficiently working alongside institutional capital.

We started our panel by examining the role of European institutions at a more macro level represented by Giorgio Chiarion-Casoni, Head of Infrastructure Unit DG ECFIN. Giorgio leads a taskforce set up by the European Commission in collaboration with the EIB and the EU member states, which has identified and analyzed some 2000 long-term investment projects all over Europe. This initiative aims at tackling low investment activity and improving the average attractiveness of post-crisis Europe on a long-term and sustainable basis as part of the Juncker initiative. The projects identified in this program cover a wide range including infrastructure, transport, energy innovation and digital economy, all aligned with the general objective to foster European growth.

The scale of such projects is generally of large public interest and on national and trans-border EU level. The three main findings of the taskforce are summarized and illustrated in the resulting report: Firstly, the need to ensure adequate financing of these long-term investments by assuring, that required resources are available at a commission level and that the projects are capable of attracting sufficient private money to bring them to fruition; secondly, stressing on the importance of establishing the right economic environment, which can be shaped along with the support of the relevant states, ensuring that it is not too cumbersome, by including key features like equality of regulation, favorable tax systems, reducing macro-economic uncertainty, political stability, transparency, predictability, accessibility; and thirdly, ensuring the visibility of the projects through media and marketing instruments, making the investors and the public aware of these opportunities.

The concrete idea behind this initiative is to create a pipeline of opportunities open to private and institutional investors. Pursuant to this, the program requires to mobilize member states at a national level, but also to co-operate cross-border, to identify, qualify and promote this type of long-term sustainable investment. The pipeline acts as a medium to connect supply and demand and to attract the respective investment resources. If this can be accomplished, the large scale of this initiative could have significant positive social outcomes, especially if it is able to attract a large public interest of return seeking investors.

At the other end of the scale, the panel discussed small, local, philanthropic investment programs, often run by purely charitable organizations with no clearly measurable financial outcomes, which operate in many forms across Europe. A good example of this type of situation is a program running in Italy, represented in the panel by Luciano Balbo and the European Venture Philanthropy Association, with which he is associated. Luciano described, how the social investment programs, he is associated with, happen mainly on local and regional level, often concentrating on deprived areas with low economic activity and a high level of unemployment. Areas of investment include education, health care and social housing schemes. The strategy of the association focuses on investments that create a positive social impact that is sustainable. Luciano makes the point, that operating in the field of social venture capital mostly aims at driving positive rather than direct economic social outcomes, and the nature of these investments bares

a high level of risk. Therefore, investors are mostly found in foundations and charitable organizations, with some private donor involvement and with limited involvement at larger institutional level.

A potential source of capital for these types of projects could also include public funds that work alongside existing donors. Given its nature, role and responsibility, the public sector cannot always take the respective risk to invest into such social innovation and get behind the development of new models that are necessary to push these kinds of regional projects. Luciano stresses, that existing financial resources on a public level are often adequate as a whole, but need to be allocated in more efficient ways. Public institutions need the flexibility to address the demands of social innovation. Also, such programs need to investigate the opportunity of creating public private partnerships that allow outsourcing of risk. The key is working with local governments, building relationships and generating the trust, necessary to facilitate alignment around common investment projects.

The reality is, that pure philanthropic projects such as the above, present a serious challenge in terms of linking them to institutional markets due to their inherent size and nature. Is it possible to bring these two worlds together? The European Fund of South-east Europe ("EFSE"), represents a successful example of exactly this idea, combining donor money with institutional investors looking for financial and social outcome. The latter, as addressed in the funds' mission statement, focuses on generating impact on three different levels: investing in micro and small enterprises to strengthen local economies through generation of income and creation of jobs, ensuring that basic needs of individuals are satisfied via housing projects and supporting local financial markets.

The fund is organized as a public private partnership and fed through funds from various donor agencies and European governments, international financial institutions as well as private investors. It is structured as a real business with efficient and regulated governance, oversight and accountability. Risk management is addressed in its "first loss" tranche, set up through existing donor or public capital, which intervenes at the very beginning in the event of losses. Figures and statistics substantiate that the fund is operating successfully by meeting expectations of the different parties involved.

Looking at the structure of the fund, it becomes obvious that the overall construct is quite complex. The fund operates at different levels, each requiring the involvement of specialist investment advisors, administrators, and financial intermediaries. Stakeholders include European and national governments investing alongside institutional debt and equity investors, microfinance institutions and local banks, who identify, qualify and manage local projects and various other parties involved on an investor and investee level. It becomes obvious, that these very complex structures, need to be managed by institutions and are supported by the advice of specialists to ensure the vehicle operates properly and investments lead to the anticipated returns and social outcomes. The results are, however, impressive. In the case of EFSE, the fund currently deploys around 1 billion Euros of capital and is involved with over 250 development projects in a sustainable model running since 2005 with consistent average returns to institutional investors, which clearly demonstrates the positive role, that institutions acting together, can play.

Another role that institutions can play in this market is that of organizations that represent investors or advisors interests as a whole, for example, trade organizations that lobby on behalf of an industry and offer support through representing common interests before governments and policy makers. Representing this view point in the panel was Francesco Briganti who is General Director of European Association of Paritarian Institutions (“AEIP”). AEIP is a lobbyist organization, representing a group of institutional investors consisting of some 1200 social protection providers, including mainly pension funds, but also health care and disability funds. In general, these institutional investors are one of the most significant players in the capital markets as a whole, and would have a very positive impact, if such funds could connect with the types of social investment programs we are discussing.

Francesco has been directed by some of his members representing small regional pension funds who have an interest to invest into regional businesses and infrastructural projects. As a consequence, AEIP started discussions with local and regional governments to see how the money can be deployed in the area of social impact investing. However, as described above, this type of investment needs to be analyzed and carefully considered on a case-by-case basis, and generally bears a high level of risk. Whilst the pension funds concerned see the long-term benefits of social investment, their first priority is to meet the financial obligations of their customers by delivering an appropriate level of returns at a reasonable overall risk level. In this process, the nature of the individual projects and also the overall attractiveness of the country play an important role.

An approach to address the AEIP members’ initiative and to meet the return needs of pension funds is the use of vehicles which pool long-term investments on a European level. This makes them more investable as they diversify potential risks. Respective regimes which address this kind of cross-border investment are the current focus of the European Union. Only recently the European Long-Term Investment Fund (“ELTIF”) regime introduced a new format of a collective investment vehicle targeting long-term investment in Europe. Francesco also makes the point that, as well as specific vehicles such as the ELTIF, the impact of financial regulation and taxation in general has a significant role in creating a favorable environment to facilitate such products. Many, including Francesco, express skepticism as to how well these environmental factors are aligned with the EU’s overall objectives in this area.

There are, for example, directives such as Solvency II, which regulates insurance companies and, in particular, the amount of own capital they have to set aside to invest in certain types of investments. Although being a purely financial regulation, if not calibrated correctly, this regulation could dis-incentivize institutions to allocate capital to social impact products. Also, if we look in detail at the commentary on the previously mentioned ELTIF regime, we notice, that opinions remain divided as to whether this really offers anything new to institutions as an investment vehicle. On the surface, it certainly offers the opportunity to invest into local and European infrastructure and businesses, thus to participate in the development of economy by benefiting from an appropriate risk and return profile. However, the complexity of the required structure,

which implies a large and diversified investment portfolio, makes it difficult to comply with the respective rules.

In addition, the introduction of a financial transaction tax does not help the marketplace overall. What would really help promote such collective investment vehicles would be the introduction of a tax neutral status, similar to a Real Estate Investment Trust, which is not currently on the table. These are all topics on which trade organizations such as AEIP lobby on constantly, on behalf of their members.

To summarize, the successful growth of sustainable European long-term investments depends on aligning a set of complex factors at all levels in the market. The role of institutions and advisors is key. If we look at the demand for capital, opportunities in the area of infrastructure and social impact investing appear to be abundant across Europe in various forms. Being able to combine public, private and institutional capital in generating a balance of both social and financial returns, should be part of the overall strategy to maximize the amount of resources that can be deployed, especially for larger scale projects. There are some shining examples of success today in the market. At the same time, we need favorable winds in terms of EU and local government policy.

Maximizing social impact of social infrastructure

Maximizing social impact using social infrastructure

John Williams

It is fundamental: public infrastructure is a requisite to healthy, productive and viable communities. In essence:

Eco-infrastructure provides the raw materials to fuel economies and to absorb their residue, Social Infrastructure equips populations to collaborate, compete and thrive:

- Water systems support life;
- Energy grids increase productivity;
- Transportation facilities enable access to markets; and
- Communications networks enhance efficiency and market participation.

Important as infrastructure is, ill-informed investments (or lack of investments at all) in infrastructure can damage quality of life and regional competitiveness. Long-term investments associated with infrastructure projects result in positive or negative performance related outcomes that can last for many decades. The social impact, “the effect of an activity on the social fabric of the community and well-being of individuals and families”¹ associated with infrastructure investments can be enormous. In the USA and for some locations in the EU, the mass development of highways and expressways in the 1950’s and 60’s left many cities circled by rings of concrete that encouraged urban sprawl, dependence on automobiles, and decaying inner cities. Most of those highways and the development patterns they encourage still exist and act as barriers to more sustainable forms of mobility. In the mean time, congestion impacts commerce and feeds asthma in millions of children.²

The New York Times reported that, “Researchers in Europe have confirmed scientifically what parents in traffic-congested Southern California have known anecdotally for years: Poor air quality associated with busy roads can cause asthma in children.” According to Dr. Laura Perez of the Swiss Tropical and Public Health Institute, “In light of all the existing epidemiological studies showing that road-traffic contributes to the onset of the disease in children, we must consider these results to improve policy making and urban planning.”³

1 Business Dictionary.com.

2 New York Times, March 21, 2013, It’s Official: Traffic pollution can cause asthma in children.

3 Ibid.

As Dr. Perez suggests, there are costs and benefits that go with infrastructure, associated services and the development of buildings. Impact investors can play a huge role in reshaping our communities by directing their capital toward projects that will improve social outcomes including the overall social and environmental state of neighborhoods, cities and regions. It will help them to know that many impacts can be quantified and valued in monetary units that are adjusted for uncertainty and risk.

The “Triple Bottom Line,” a term first coined in 1994 by John Elkington, the founder of a British Consultancy called SustainAbility⁴ was born out of his belief that, “companies should be preparing three different (and quite separate) bottom lines”.⁵ He referred to these as separate accounts to reflect measurement of returns or outcomes associated with “profit, people and the planet.”⁶ Since 1994 there have been many iterations of Elkington’s three Ps with one of the most accepted being the financial, social and environmental attributes associated with a given undertaking (TBL results).

More recently, there has been a movement to consider another category or attribute focused on degree of resiliency a community may achieve. Judith Rodin, President of the Rockefeller Foundation in her book entitled, “The Resilience Dividend,” defines resiliency as, “the capacity to bounce back from a crisis, learn from it, and achieve revitalization.”⁷ According to the Wall Street Journal, Rodin is especially worried about the problems created by urbanization, climate change and globalization.

Non-financial returns such as community health, worker productivity, emissions impacts, social networks and recreational value of an acre of wetlands are often described as “intangibles” asserting the values of these are either difficult or impossible to calculate with any degree of confidence. As a result, they are frequently discounted or overlooked in long-term investment decision making. The expense and time required for due diligence, lack of metrics and standards, and technical capacity are cited as reasons to look no further than financial returns. As a result, investors are sometimes steered away from opportunities that involve infrastructure projects and their benefits.

Avoidance of infrastructure projects is unfortunate and unnecessary as major elements of the TBL + Resilience Dividends, are calculable in monetary units and adjustable for uncertainty. Impact investors can demand analysis of these values. The new economic foundation (nef) is a UK based think tank that has developed tools for valuing social returns on investment. In the United States, the Clinton Global Initiative (CGI) in 2009 hosted the launch into the public domain of the Sustainable Return on Investment (SROI – but hereafter using the acronym SUROI for an EU audience⁸) Framework, an outcome of a CGI Commitment to Action led by the author of this chapter. SUROI uses Benefit-Cost and risk analysis to determine the value of public and

4 The Economist, November 17, 2009, Triple Bottom Line.

5 Ibid.

6 Ibid.

7 The Wall Street Journal, November 20, 2014, Never Waste a Crisis.

8 SUROI in the USA but not to be confused with Social return on Investment used across the EU so, for this chapter we will use the acronym SUROI.

environmental benefits associated with infrastructure and building projects stated in risk adjusted monetary units (US and Canadian Dollars).

Nearly \$12 billion in actual projects across a broad array of types (transportation, energy, healthcare, education, water, waste management facilities) have been subjected to elements of the SUROI framework to value the financial + social + environmental costs and benefits determining their value for money.⁹

Socially Responsible, ESG, Green Bond or Impact investors (foundations, family offices, pension fund trustees and others that control tens of trillions of dollars in capital worldwide) can use TBL valuation tools to inform decision making as they direct capital toward opportunities that can lead to social benefits. The use of TBL based business cases will reveal that there are few investments that can yield TBL results on a scale comparable to infrastructure and public building projects.

Financial returns (particularly short-term) are the primary benchmarks determining/driving/underlying compensation for investment professionals. It is not surprising that investment advisors, analysts, institutional consultants dismiss valuation of anything but financial return as the “only thing their clients are interested in.”

That position is contradicted by the movement of massive amounts of capital into investment categories that are marketed as leading to some form of social impact – beyond financial returns (very visible in the USA, Canada, Australia and New Zealand).

According to the World Economic Forum, “Over the next 40 years, Generation X and the Millennial Generation will potentially inherit an estimated \$41 trillion from the Baby Boomer Generation.¹⁰ These generations have grown up in a culture that calls on business to play a more active role in society. In fact, in a recent study of 5,000 Millennials¹¹ in 18 countries, respondents ranked, “to improve society” as the number one priority of business.”¹²

Expectations are rising that the value of social benefit or even the value of “green” needs to be determined as material parts of the fiduciary process.

The balance of this chapter will focus on debunking the assumption that the “less tangibles” cannot be valued, lack a standard, require expensive analysis and are impossible to compare. Evidence will be provided to support the claim that public and private infrastructure project investments should be prioritized on a basis of total TBL returns.

9 The City of Edmonton, HDR, SROI Sustainable Return on Investment, the City of Edmonton: Sustainable return on Investment Analysis of LEED® Certification Levels for New Building Construction, May 30, 2014.

10 John J. Havens and Paul G. Schervish (2003): Why the \$41 Trillion Wealth Transfer Estimate is Still Valid: A Review of Challenges and Questions, Boston College Social Welfare Research Institute. Note: The US\$ 41 trillion is the researcher’s low-growth scenario estimate and assumes 2% real secular growth in assets.

11 Millennials” are born after January 1982; those included in the study were Millennials from 18 countries who have a degree and are in full-time employment. Survey conducted by Deloitte in 2012.

12 World Economic Forum, From the Margins to the Mainstream Assessment of the Impact Investment Sector and Opportunities to Engage Mainstream Investors, A report prepared by the World Economic Forum Investors Industries Prepared in Collaboration with Deloitte Touche Tohmatsu, September 2013.

Public benefit can be valued

Standards exist for assessing the value of infrastructure and public building projects. Benefit-Cost Analysis (BCA) has been the default standard used worldwide for more than a century. The HM Treasury THE GREEN BOOK Appraisal and Evaluation in Central Government provides an Overview of Appraisal And Evaluation Cycle in Chapter 2 section 2.3 entitled The Role of Appraisal states that, “Appraisals should provide as assessment of whether a proposal is worthwhile, and clearly communicate conclusions and recommendations. The essential technique is option appraisal, whereby government intervention is valued, objectives are set, and options are created and reviewed, by analyzing their costs and benefits.

Within this framework, cost-benefit analysis is recommended, . . . with supplementary techniques to be used for weighing up those costs and benefits that remain unvalued.”¹³ The GREEN BOOK defines Cost-Benefit Analysis as Analysis which quantifies in monetary terms as many of the costs and benefits of a proposal as feasible, including items for which the market does not provide a satisfactory measure of economic value.¹⁴

In the USA, the U.S. Department of Transportation has recognized the Benefit-Cost Analysis as the accepted method for establishing the value of merit associated with grant applications. In fact, it published the BCA Resource Guide as a supplement to the 2014 Benefit-Cost Analysis Guidance for Tiger Grant Applicants.¹⁵

Until recently, the complexity of applying BCA on infrastructure projects has made it cost prohibitive for all but the largest projects. The complexity was a function of the need for significant amounts of credible, objective, current and transparent data on which to base analysis. Raw “data” by itself is not enough. It is essential that information used to calculate TBL values of infrastructure projects must be current and sector specific (i.e., energy, water, mobility, healthcare, social housing, etc.).

Metrics must also address geographic and market specific conditions. Assessments are undertaken by specialty consultants with backgrounds in economics and risk assessment and hopefully, in depth knowledge of infrastructure, buildings and the delivery process. They have created custom studies that are project specific thereby making them useful in determining if the project has sufficient merit to proceed.

From a demand perspective, custom studies are expensive and are apt to be used to justify large projects (€100+ million) at their inception (not as projects change during detailed planning, design and construction). From a supply side perspective, custom assessments are complex and seen as adding to due diligence burdens. From an institutional perspective, they are difficult to compare and lack utility in performance monitoring and reporting.

13 HM Treasury, THE GREEN BOOK Appraisal and Evaluation in Central Government, Treasury Guidance, LONDON TSO, July 2011.

14 Ibid.

15 U.S. Department of Transportation, Office of Economic and Strategic Analysis, Benefit-Cost Analysis (BCA) Resource Guide, July 10, 2014.

On the other hand, significant evidence exists to prove that BCA can be applied systematically to infrastructure and building projects to facilitate comparisons based on comprehensive TBL based business cases that followed a similar analytical process. An excellent example is found in the USA.

The Tiger Grant Program, a multi-billion dollar, multi-year merit based grant program utilized a common approach to BCA to sort through thousands of merit based funding applications to select those that represented the greatest overall value for money including the value of public benefit or social benefit. Tiger has awarded more than \$6 billion since 2008. Applicants that were not able to articulate an objective, transparent, and consistent approach to their business case were passed over (In 2014 TIGER applicants requested 15 times the available funds).¹⁶ In the private sector and more specifically publicly traded companies are seeing benefits.

TBL Analysis can be Affordable especially for public authorities and NGOs that often represent demand-side interests – thanks to advances in technology. Technology including cloud based computing allows access to and efficient analysis of vast amounts of high quality, infrastructure and community specific data (much of which is available in the public domain, free of charge and in real time). That data includes peer reviewed research and meta-analysis studies (studies of large numbers of studies) that address the majority of concerns related to sourcing adequate amounts of objective information on which to base comprehensive assessments.

In addition, advances have been made in the development of sector specific metrics and analytical tools (example being the ISI Envision's BCE¹⁷ for Stormwater Management to be followed by Water/Wastewater; Transit; Buildings; and Highway, Bridges and Roads) backed by billions of dollars in applied valuation experience in the USA and Canada. Those tools account for geographic specificity including market factors like labor, real estate, energy prices, and carbon valuations.

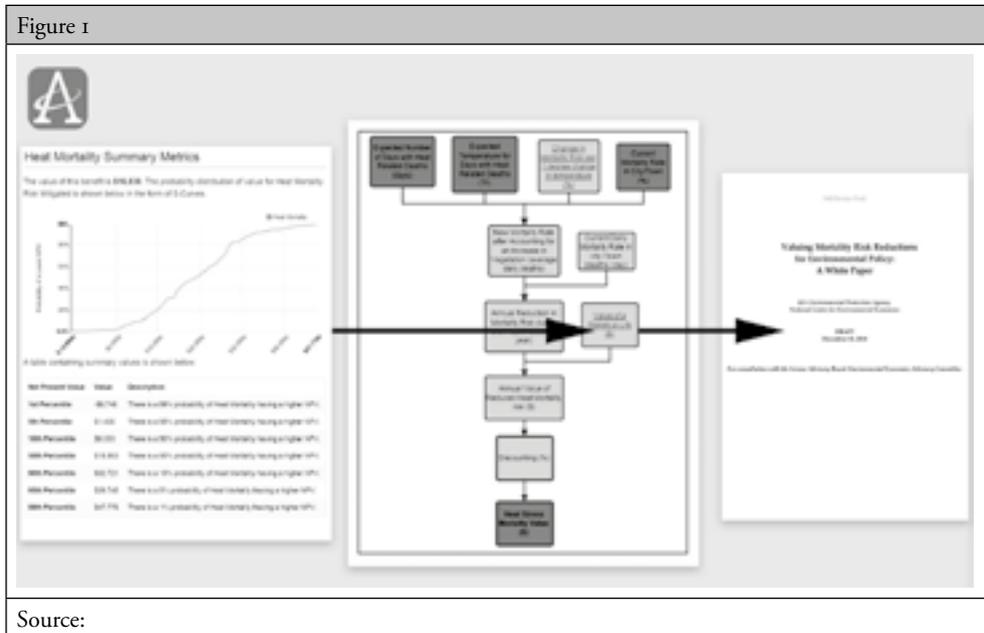
Thanks to the minimal cost of applying BCE analysis, comprehensive TBL based business cases can be utilized at each step in the project development process from the initial TBL case of early planning to revisions at conceptual, preliminary and final design, throughout construction and long-term operations. Cases can be run and re-run each time key decisions are made so that the certainty associated with the case and project improves as additional data becomes available.

Cloud based tools are emerging that will enable project development professionals including planners, engineers, architects, financial analysts and project sponsors to provide data needed to inform the due diligence process while solving cost, transparency, and comparability issues. For example, project assessment software includes

16 U.S. Transportation Secretary Foxx Announces 72 TIGER 2014 Recipients <http://www.dot.gov/briefing-room/us-transportation-secretary-foxx-announces-72-tiger-2014-recipients>.

17 The BCE (Business Case Evaluator) developed by Impact Infrastructure, Inc. with input from ISI's Economics Committee, v1.0 was first released into the public domain in September 2013 and v3.0 was released in January 2015, the author of this chapter is a principal owner of Impact Infrastructure, Inc.

AutoCASE^{®18}, leverages sector specific metrics enabling them to run on a common analytical engine that is informed by data harvested from Building Information Modeling (BIM) software. BIM software is used by millions of professionals around the world.¹⁹ Soon, they will be able to run real time TBL assessments of each project planning or design alternative under consideration.



AutoCASE runs Multiple Account Benefit Cost Analysis in conjunction with TBL assessments to show results that are sorted by returns to specific stakeholder groups. That capacity matters to demand, supply and institutional investors because it answers the “what’s in it for me?” Answering this question for project stakeholders leads to a more balanced distribution of net benefits and so reduces schedule, construction cost and political risk. By revealing the value of benefit to project financiers, host governments, tax or rate payers, the local economy, and the environmental community, TBL analysis can accelerate project delivery and the realization of benefits.

Cloud based technology make it possible to store project specific data for on-going analysis as plans are refined and design, construction and operational decisions are made. This is particularly valuable over the long-term as business case data can be used as a monitoring baseline against which to measure and report changes in projected outcomes resulting from decisions during project planning, development, commissioning

18 AutoCASE[®] was developed by Impact Infrastructure, Inc. and is being offered worldwide in conjunction with a series of Autodesk Building Information Modeling software, the author of this chapter is a principal owner of Impact Infrastructure, Inc.

19 Autodesk market data.

and long-term operations. Fund managers will find TBL baselines to be of value in addressing investor expectations of performance reporting over time.

Different infrastructure projects can be compared on a basis of Total Returns. TBL software deconstructs projects into categories of costs and benefits, tangibles and less tangibles making comparisons possible on a basis of value associated with outcomes regardless of project type, size and location. Projects can be compared by NPV of Financial Return on Investment (NPVFROI) as well as NPV of Sustainable Return on Investment (NPV SUROI). That capacity allows investors to compare different projects and to select from a range of opportunities (i.e., energy, water, mobility, education, healthcare, and communications) that deliver the greatest overall public benefit in exchange for capital regardless of project type, size or location.

Technology enables project professionals to contribute transparent, objective data into the due diligence process enabling cost and time savings within the institutional and investing community. These attributes – the ability to compare dissimilar projects on a total return basis – address many of the challenges associated with project bundling needed to increase the efficiency of transactions by lowering related due diligence costs while expanding the number of projects that can be included in a portfolio. As stated earlier, the same technology can be used to establish performance baselines for project monitoring and reporting over the life of specific projects or systems.

Investment prioritization based on total TBL returns will be the norm for Impact investors, be they focused investors, pension funds, (re)insurance companies, wealthy individuals, family offices, foundations, pension funds, or even governments at all level. Each type of investor shares an interest in securing reasonable returns (at reasonable risk) as well as some other additional benefits that may include social, environmental and/or resilience outcomes.

Growing excess demand combined with ongoing shortages of capital provide an incentive for making well informed decisions. In the past, most of those decisions were made without consideration of total returns (beyond financial and political). As a result, investments in the trillions of dollars, Euros or Yen were made in long lasting assets with lasting positive and negative implications.

Today, narrow, blind or shortsighted investments cannot be tolerated. The societal stakes are high, the need is great but the news is good. Investment Professionals will be able to harvest objective, transparent and comparable data from the comprehensive business cases that accompany project proposals. The supply side and institutional professionals can require demand side project sponsors to provide comprehensive TBL data at sponsor expense. Sponsors will engage their professional planning, engineering and design staff or consultants to run the TBL based business cases. Those professionals are generally licensed and subject to oversight and penalties for performance below established professional standards. Access to credible data sources from licensed professionals will reduce the analytical capacity challenge that currently exists in the investment community and at the same time, reduce due diligence burdens.

There is an additional benefit associated with the increased ability to compare disparate projects on a basis of total risk adjusted financial, economic, social, environmental,

and resilience returns. Project bundling will be accelerated and supply side and institutional investors will be able to see how bundles deliver total returns that matter to their stakeholders. Institutional players including pension funds that control massive amounts of capital and have shown a desire to engage in impact investing. According to Luther Ragin at Institutional Investor, “During the past five years the coordinated global effort to develop a standardized marketplace has directed more attention to impact investing. The movement to use finance for social and environmental good reached a new milestone last June when U.K. Prime Minister David Cameron hosted the Social Impact Investment Forum, a G-8 event. More than 90 major institutions active in impact investing voiced their support of the G-8’s commitment to advancing the industry.”²⁰

Ragin went on to report that, “Many impact investors accept below-market returns to test new and challenging markets and to support higher-risk early-stage social enterprises.”²¹ Thanks to technology, cloud based solutions, and tools that are affordable and accessible to millions of licensed professional worldwide, institutional investors will soon be able to see how their participation will result in financial returns as well as economic, social, environmental, and/or resiliency benefits that have value to their stakeholders and can strengthen their influence.

By assigning value to the range of benefits, it is possible to rebalance solutions and project financing to secure capital investments needed for implementation. Project sponsors can swap value of benefits that may not otherwise be realized without private capital, for capital, a portion of which may cost more than tradition tax or rate supported financing. This outcome oriented, blending would address a major barrier to Impact capital participation in infrastructure and public building financing.

There is an analytical capacity gap within the demand-side and institutional investment communities that can be filled by in house capacity building or externally by project delivery professionals that leverage use of TBL technology along with their knowledge of development initiatives. Delivery professionals will be paid by project sponsors to craft objective, transparent, BCA based cases that are comprehensive in nature and designed to address critical questions from project stakeholders including the participants in the funding/financing process.

Access to dynamic data will allow elected officials to make credible cases for outcomes that reach five, ten, and even twenty five years beyond their terms in office. They will be able to claim responsibility for creating future benefits or point to long-term costs that their decisions will help to avoid. The ability to show and tell their stakeholders a credible story is extremely valuable.

Maximizing social impact using social infrastructure requires that the demand, supply and institutional sides of the investment community pay close attention to the TBL – financial, social and environmental values of investments made in infrastructure. Without careful consideration, past practices that led to long-term commitments to fa-

20 InstitutionalInvestor.com, Unconventional Wisdom, Impact Investing Meets Financial and Philanthropic Expectations, Kuther Ragin, March 15, 2014.

21 InstitutionalInvestor.com, Unconventional Wisdom, Impact Investing Meets Financial and Philanthropic Expectations, Kuther Ragin, March 15, 2014.

cilities and services that are not sustainable will continue. Thanks to technology that will soon be available to millions of licensed professionals, worldwide, comprehensive TBL based business cases will articulate the costs, benefits and long-term returns associated with their offerings. Projects of all sizes will be able to tap the power of objective, transparent, and comparable data. These business cases will be a routine step in the development process that is paid for by the project sponsor focusing demand side sponsors and supply side investors on the global standard for project valuation (BCA), and each project can be reduced to a credible summary of financial value and value of public benefit.

This progress represents the removal of major barriers to private capital participation in public infrastructure and building projects. The same tools will address the need to establish performance baselines that will be used to address investor performance measurement, monitoring and reporting requirements.

Concluding with good news, these tools already in use in North America and will be deployed soon through an existing global network of project delivery professionals that are eager to work with the investment community (externally or by supporting development of in house capability) to re-launch fixed, network and social infrastructure – on a basis of total anticipated near, mid, and long-term returns.

Focus on philanthropists, impact investors and venture capital

Luciano Balbo

I'm talking on behalf of European Venture Philanthropy Association, created 10 years ago, whose I'm co-founder. This Association gathers both Foundations active on Venture Philanthropy model promoting Social Innovation and Social Venture Capital – or, as now it is said, Social Impact Investing – Funds, which promote sustainable investments aimed to create a positive social impact as part of their strategy and not a sort of side product.

It's really a small market: there're no more than 10-12 players in Europe; basically, they're small Funds (Bridge Venture is the largest in UK, with more than 100 M Euro). Recently EIF (European Investment Fund) has created a facility for impact investing, which works as a Fund of Funds and has started to invest in Germany and in Italy trying to promote such a kind of investments.

What do we do? I'll try to describe some examples in order to define the rationale of our activity. Basically our Funds invest in Education, Healthcare, Social Housing and in the poorest areas of our country (typically, the South of Italy, the North of UK or other deprived areas where the level of unemployment is very high and the economic activity is underdeveloped). These are the examples. What is the rationale? Typically, we think that private money has to complement public money, but I do not believe that this is the right rationale, because the private money involved in those (social) areas is really small compared with the public money invested in these sectors: the issue is therefore not to complement, but to develop new models. What we need is social innovation.

In our Countries, in Europe, the GDP is typically fifty-fifty: fifty pro cent is private and fifty pro cent is public (more or less: in US the public GDP is a little bit lower, while in France it is a little bit higher). The fifty pro cent private has been – wrongly or rightly – substantially changed by technology and innovation in the last fifty years, while the other fifty pro cent (and we're not talking about the Army, but about the social expenditure, that represents approximately the twenty five pro cent of the GDP in all our Countries) is still the same: no innovation from the State and no innovation from the private players, because the private players work for the Governments through outsourcing, so that they're requested to provide their services in the same way of the public providers: they can be a little more efficient but they cannot innovate. And this is our problem.

Recently – 2 or 3 years ago – the OECD published a study offering a different view: typically we think that social expenditure is high in Sweden and in Denmark, lower in other European countries and very low in US. This is not true. This OECD report

measured the social expenditure in the right way, so that they put together the public expenditure and the “out of pocket” expenditure of the citizens, discovering that it is all the same: the social expenditure is about 25% of the GDP in US, in Denmark and in Finland.

The issue is not the money, but how the money is spent. If in one country the social expenditure is more effective, we can offer more welfare with the same amount of money. This is the challenge of the future. Actually, the whole amount of the money spent by our countries in the social field is huge, even during the economic crisis we are facing, Italy first: it is more than 25% of our GDP. Our issue is therefore not whether to reduce or to increase the social expenditure of one percentage point: our issue is Public Policy, because if we do not change our public policy we'll not save our Europe. We need to develop new models, and I give you an example: think about all the huge amount of money from European Funds that had been spent and invested in the southern regions of Italy (and probably it has happened the same in North Uk and in other countries) to train young people.

This huge amount of money made many intermediaries rich in Italy, but has produced no result. If you've not any economic activity, training is useless. For what? The best thing for these young people is to emigrate to Germany. So this is not the best way to use our money. We need to use in a different way the current money. Since it is over, we cannot think to increase it. So what can we do? We need to develop new models, with a different approach of the public sector. The public sector all over Europe is providing a part of our services not directly, but in out-sourcing, and this does not help social innovation. We need partnerships, and we need that public sector to change its role.

The public sector has a lot of money, and says: “I want to find a new way to manage some schools: this is my budget, I've no more than it. I made one option not based on money, but on different options in healthcare and in other areas. If it works, there's evidence to go ahead, if it doesn't work I can stop the contract.” This is the only way to develop innovation. They cannot be changed with a law. People must see how do they work. But the resistance to the change is so high, that we'll not change anything. So this is our target, very difficult. We're small. Probably you'll think this is a dream. Maybe it is a dream. The only reason to have a dream is that all other things that are daily mentioned do not work. It is easy to tell a story that accomplishes all the players, but if they do not work we need to look at major changes.

How to attract more money? In our case, our investors are Foundations and Private money. Institutional Investors do not invest for many reasons: they're third part, they don't want to take a risk, some of our funds pay a trade-off between financial return and social return with higher risk.

We want a change of the behavior of the public sector, we need success stories and this is up to us to show that we're able to develop success stories. We have to change our expectation for returns.

I think there's one wrong thing in the word. The developed world is not performing so well. Wages are falling day after day, but private wealth has never been so large (the private wealth is 5-7 time the GDP) and there's a difference with the past, as Mr Picketty shows: one century ago it was “land and buildings”, now it's cash. If you don't use better this money any policy will never work.

From good to growth. Promoting social investment and public good¹

Fiorenza Lipparini, Seva Phillips, Filippo Addarii, Indy Johar

“Just as it took the New Deal and the European social welfare state to make the Industrial Revolution work for the many and not the few during the 20th century, we need new social and political institutions to make 21st century capitalism work for the many and not the few.”

Center for American Progress, Report of the Commission on Inclusive Prosperity, 2015

This paper makes the case for using the new €315bn European Fund for Structural Investment to foster investment into: (i) human capital development programmes (“social investment”); (ii) projects which achieve both financial and social returns (“public good”) and (iii) multi-stakeholder partnerships which systematically address entrenched social issues (“systemic social innovation”). Together, these will stimulate economic growth across the European Union.

We have made this case because it is clear that austerity alone cannot put Europe back on the path to growth. Through a comprehensive literature review and discussion of case studies, we illustrate the power of collaborative approaches between the public, private and third sectors.

- ¹ The present chapter has been written in the context of the EU funded project DOLFINS – Distributed Global Financial Systems for Society, coordinated by Prof. Stefano Battiston from the University of Zurich. The project aims at making the financial system better serve society by placing scientific evidence and citizens’ participation at the centre of the policy process in finance. It investigates with a multidisciplinary approach how to achieve financial stability and facilitate the long-term investments required by the transition to a more sustainable, more innovative, less unequal and greener EU economy. The chapter is based on the research paper “Making impact real. Why the role of social infrastructure and public good investment are key to stimulating the European economy and how we can encourage them”, undertaken by the Young Foundation’s EuropeLab/SmallWorldLabs in the context of a broader research project on “Growth and Investment in the European Union”. The project was led by the European Policy Centre and sponsored by Unipol Financial Group. The research paper is based on a wide bibliographic review and on data and insight collected through semi-structured interviews with members of the project’s Advisory Board and expert practitioners. We are thankful to Nicolas Bearelle (Re-Vive), Fiammetta Fabris and Maria Luisa Parmigiani (Unipol Group), Filipe Santos (INSEAD/Social Innovation Portugal) and Simone Santi, Duncan Pelham and Iain Smith (Lend Lease) whose contributions were used to write this chapter.

We argue that a multi-stakeholder approach is essential properly to respond to the complexity of social needs. We show that public funds have the potential to leverage private capital, providing the resources to create social change.

1. Setting the scene: inclusive economic growth

Seven years after the beginning of the global financial crisis, it is clear that it will take more than austerity measures alone to put Europe back on the path to growth. In this paper, we argue that if we want to leave the crisis behind it is necessary to stop thinking of economic and social policies as two separate entities. We need not only to invest more in social protection and public goods and services, but also to involve the private sector and civil society, (that is businesses, civil society organizations and citizens) in this effort.

In this chapter, we outline how pervasive inequality is a barrier to economic growth, set out existing EU social policy initiatives that have an impact on inequality and reflect on the opportunity presented within the European Commission's new investment package.

1.1 Growing inequality & its economic impact

The heavy social consequences of the financial crisis in terms of rising inequality and unemployment put the spotlight on the limits of 20th century capitalism, highlighting how most of the free-market democracies that achieved the highest GDPs across the world after the Second World War failed to raise the living standards equally across their populations. The gap between rich and poor is today at its highest level in most EU countries in 30 years, and, since the 1980s, productivity growth has not translated into a commensurate increase in incomes for the bottom 90% of earners². Redistribution policies have not kept pace with rising market-inequality³. To make matters worse, income

- 2 See Centre for American Progress. *Report of the Commission on Inclusive Prosperity*, 2015 and Furman J. (2014). *Global Lessons for Inclusive Growth*. Dublin: The Institute of International and European Affairs: "In the United States to a greater degree, and in other OECD countries to varying degrees, the bigger source of the failure to generate sustained gains in middle-class incomes has been the fact that productivity growth has not translated into a commensurate increase in incomes for the middle class. The gap between aggregate productivity growth and the measure of middle class income growth (...) is particularly stark in the United States, United Kingdom and France".
- 3 Cfr. OECD, *Society at a Glance 2014*: OECD Social Indicators, OECD Publishing, 2014: "today the richest 10% of the population in the OECD area earn 9.5 times the income of the poorest 10%; where the ratio was 7:1 in the 1980s. While over the 20 years leading up to the crisis, average real disposable household incomes increased everywhere – on average by 1.6% annually –, in three quarters of OECD countries income at the bottom grew much slower during the prosperous years and fell sharply during the downturns, resulting in widening income inequality. (...) Differences in the pace of income growth across household groups in the pre-crisis period were particularly pronounced in most of the English-speaking countries but also in Israel, Germany and Sweden. The picture changes when looking at the post-crisis period (i.e. the years from 2007 through 2011/12) as average real household income stagnated or fell in most countries, particularly – by more than 3.5% per year – in Spain, Ireland, Iceland and Greece. In almost all countries where incomes fell, those of the bottom 10% fell more rapidly. Similarly,

inequality deepens inequality of wealth and implies inequality in accessing essential services like healthcare, education and, even more disturbingly, translates into unequal life-expectancy⁴.

Income inequality though, is not only unfair and politically undesirable, it has also sizable negative effects on economic growth.

According to a recent OECD report⁵, an increase in inequality by 3 Gini points – the average increase registered in the OECD area over the past 20 years – means a cumulative loss in GDP of 8.5% over the same time period. If we look at the performance of single countries, we find that rising inequality has knocked nearly 9 percentage points off growth in the UK, Finland and Norway and between 6 and 7 points in Italy and Sweden.

OECD also finds that “the biggest factor for the impact of inequality on growth is the gap between lower income households and the rest of the population. The negative effect is not just for the poorest income decile but for all of those in the bottom four deciles of the income distribution”⁶. The consequences on consumption levels are increasingly apparent. As shown by Cynamon and Fazzari⁷ in the United States, the share of disposable income consumed by the top 5% of households in the 1989-2008 period was substantially below that of the bottom 95%. The limited borrowing possibilities for lower income households due to the financial crisis caused a strong contraction in the consumption of goods and the overall demand, slowing the recovery process.

Based on the longitudinal analysis of cross-country data sets, it is clear that there is a negative correlation between the level of net inequality and growth in income per capita, while redistribution has an overall pro-growth effect.⁸ Moreover, inequality has a statistically significant negative relationship with the duration of growth spells: a 1 Gini point increase in inequality translates into a 6 percentage point higher risk that a growth spell will end in the next year.

In conclusion, “it would be a mistake to focus on growth and let inequality take care of itself, not only because inequality may be ethically undesirable but also because the resulting growth may be low and unsustainable. And second, there is surprisingly little evidence for the growth-destroying effects of fiscal redistribution at a macroeconomic level.”⁹

in about half of those countries where incomes continued to grow, the top 10% did better than the bottom 10%.

4 See Centre for American Progress (2015).

5 Cingano, F., *Trends in Income Inequality and its Impact on Economic Growth*, OECD Social, Employment and Migration Working Papers, No. 163, OECD Publishing.

6 OECD, *Focus on Inequality and Growth* – December 2014.

7 Cynamon and Fazzari, *Inequality and Household Finance during the Consumer Age*. Levy Economics Institute of Bard College, Working Paper No. 752, 2013.

8 Jonathan D. Ostry, Andrew Berg, Charalambos G. Tsangarides, *Redistribution, Inequality, and Growth*.

9 Ibidem.

1.2 *The European context and the new European Commission Investment Plan*

1.2.1 *The European context*

The idea of boosting economic growth by using social policy to tackle inequality – in addition to purely economic approaches – is not new in European policy.

The European Semester process, introduced in 2010, has encouraged European Member States to further deepen the coordination of their economic and budgetary policies with the aim of reaching the agreed Europe2020 targets for employment, innovation, education, poverty reduction and climate/energy¹⁰.

This means that for the first time the EU is considering social policies as part of the economic governance process so that they can be effectively discussed and monitored at EU level. The social impact assessment that will accompany fiscal sustainability assessments for countries in Excessive Deficit Procedures is another step in the process of bringing together social and economic policies, while – also thanks to the European Parliament's input¹¹ – Member States not complying with the Commission's Country Specific Recommendations will be increasingly under pressure to justify such actions.

The importance of involving civil society, social entrepreneurs and businesses in the process of reconciling economic progress and social impact has been acknowledged in a number of European policies. These are outlined below.

The central role given to social innovation in the Innovation Union Flagship Initiative has resulted in a wide number of regulatory and non-regulatory actions, from the Social Business Initiative to the European Entrepreneurship Funds (EuSEFs) Regulation to the new directive on public procurement which integrates social considerations into contracting procedures.

The Social Investment Package launched in 2013 fully recognized the importance of both ensuring adequate and sustainable social protection and promoting social investment across Europe. It called for a more efficient and effective use of member states' social budgets and made the case for the modernization of welfare systems.

In addition, EU funding to help member states achieve smart, sustainable and inclusive growth is being disbursed through a number of programmes directly managed by the Commission (as Horizon2020 and EaSI), but especially through the EU Cohesion Policy, which will make available up to €351.8 billion to Europe's regions and cities by 2020.

In spite of this rich policy context, the practice of taking into account social impact is not yet mainstreamed within the criteria presiding financial decisions for the allocation of EU funding. This is a missed opportunity, because, as we will see in the next

10 Namely: 75% of 20-64 year-olds in employment by 2020, 3% of the EU's GDP to be invested in RDI, early school leaving rates below 10%, 40% of 30-34 year-olds with third-level education, 20 million fewer people in or at risk of poverty and social exclusion, reduction of greenhouse gas emissions at least 20% lower than in 1990; 20% of energy from renewable sources and energy efficiency.

11 See in particular Art. 62 to 76 of the EP Report on the European Semester for economic policy coordination: implementation of 2014 priorities, chaired by Philippe de Backer MEP.

chapter, the business sector is more up to the challenge than is normally assumed. In this regard, Juncker's Investment Plan offers a formidable opportunity.

1.2.2 The opportunity of the European Fund for Strategic Investments

The Juncker's Investment Plan for investment was launched in November 2014 with the aim of catalysing private investment into the European economy. Indeed, EU firms still have great investment capacity (according to McKinsey¹², EU listed companies had cash holdings in excess of €750bn in 2011); the idea is to make investment in the real economy more attractive than financial speculation by providing EC/EIB backed guarantees, a pipeline of credible projects and a favourable and predictable regulatory framework.

The focal point of this plan is the newly established European Fund for Strategic Investments (EFSI), capitalised with €21bn of EU funds.

According to the Commission's calculations, the fund will mobilise at least €315bn of public and private investment over the next three years (2015-2017). The fund will mainly invest in strategic infrastructure (digital and energy investments in line with EU policies), transport infrastructure in industrial centres, education, research and innovation, SMEs, environmentally sustainable projects and Research and Innovation, and it will do so either directly or through intermediaries. More precisely, the Commission plans to invest up to three quarters of the resources to support private fund structures such as the European Long-Term Investment Fund (ELTIF), set up by private investors and/or National Promotion Banks (NPBs).

EFSI in practice

Establishing a pipeline of viable projects and making sure that they are compliant with all relevant regulatory and administrative requirements is essential to attract private investment. For this purpose, a Task Force has been set up by the EC and EIB, together with the Member States to screen potential projects according to four key criteria:

1. EU added value (i.e. projects must be consistent with EU objectives)
2. Economic viability and value (projects with high socio-economic returns will be prioritised)
3. Maturity (projects should start within the next three years)
4. Potential for leveraging other sources of funding

Projects should also be of reasonable size and scalability (differentiating by sector/sub-sector), even if this can take account of the bundling of smaller investments. The pipeline will be transparent and open, meaning that member states, including regional authorities and NPBs, European institutions and private investors will be able to contribute to the pipeline by presenting or sponsoring projects.

Selected projects will then be assessed by a dedicated independent investment committee made up of experts that will have to validate every project from a commercial and societal perspective and based on what added value they can bring to the EU as a whole.

12 Roxburgh, C. et al, *Investing in growth: Europe's next challenge*, McKinsey Global Institute, 2012.

The opportunity

The assessment of projects' "societal value" presents an unparalleled opportunity to change the way to invest in Europe. We argue that it has the power to bring about a new phase of economic growth and democratic participation. To capitalise on this opportunity, we suggest that:

- All projects, including "hard" infrastructure projects (for instance in the transport, digital and energy domain) are assessed for their social investment dimension (for instance in terms of local work-force upskilling or RDI activities) or for the social impact they want to achieve (for instance in terms of jobs created or goods/services of public general interest made available);
- Projects specifically targeting social investments or investments in public good should be included in the projects pipeline as ends in themselves and not only as a complementary investment to hard infrastructure; for instance by ensuring that impact investment funds such as the EIF backed Social Impact Accelerator are among EFSI's investment options or by encouraging impact investors and third-sector organizations to present and sponsor projects in the pipeline alongside public and private investors.

In the next chapter, we will show through a series of concrete examples how social investments and investments in public good, are not only desirable from a macro-economic perspective – because of their contribution to restraining inequality and enhancing long-term sustainable growth – but can also be economically rewarding in the short-medium term for private investors.

2. Private capital for social investment and investment in the public good: why (and how) it works

To develop the right conditions for sustainable growth we need to reduce inequality. To pave the way for possible approaches, this chapter explores the rationale for social investment and public good investment, in themselves and for each, provides examples of how collaborative approaches between the public and private sectors can foster these. In the conclusions we will recommend how these collaborations can be encouraged through the EFSI package.

2.1 Social investment

Definition

In line with the Commission Communication Towards Social Investment for Growth and Cohesion¹³, we define social investment as those social policies and initiatives that

13 European Commission, *Towards Social Investment for Growth and Cohesion – including implementing the European Social Fund 2014-2020*. COM(2013) 83 final: "Social investment involves strengthening people's current and future capacities. In other words, as well as having immediate effects, social poli-

contribute to the prevention of social problems and the enablement of individuals to be more in control of their lives. It involves strengthening people's current and future capacities.

2.1.1 *The consequences of inadequate social investment*

The facts speak for themselves: countries with high levels of public spending on social protection and social services such as the Scandinavian countries have performed better in economic terms in the last decade compared to most other industrialized countries and have been less affected by the crisis. In fact, as highlighted by Hemerijck “extensive comparative empirical research has since the turn of the century revealed that there is no trade-off between macro-economic performance and the size of the welfare state”¹⁴. On the contrary, there is a positive correlation between a large public sector, high rates of employment (particularly of women's employment), high fertility rates, reduced poverty (and particularly child and in/work poverty) and general economic competitiveness.

Fiscal consolidation efforts required by EU member states in the framework of the Stability and Growth Pact have led to dramatic cuts in public spending, which could lead to increased poverty and inequality and could therefore jeopardize the efforts undertaken so far to re-ignite growth.

According to OECD projections¹⁵, expenditure cuts will account for more than two-thirds of the planned consolidation efforts between 2011 and 2015, and welfare services and infrastructure are likely to be the most affected. It must also be considered that increases in social spending have been lower in the EU member states more severely hit by the crisis, with some countries already experiencing a decline (for instance in Greece social spending fell from 24% of GDP in 2009 to 22% in 2013). Furthermore, the mix of welfare spending in the crisis years has changed, with cuts affecting mainly those services that strengthen people's current and future capacities throughout their lives, preparing them to confront risks rather than simply repairing the consequences. So, while old age and unemployment benefits kept growing in most EU countries even after 2012, active labour market and work-life balance measures, health disease prevention, education (including early childhood education and care) and training, have been subject to massive cuts.

The consequences are clear: not only will cuts to preventative social policies translate into reduced economic growth and tax revenues, but they are likely to increase reactive social policy spending too.

cies also have lasting impacts by offering economic and social returns over time, notably in terms of employment prospects or labour incomes. In particular, social investment helps to ‘prepare’ people to confront life's risks, rather than simply ‘repairing’ the consequences”.

14 Hemerijck Anton 2012: “Two or three waves of welfare state transformation?” in N. Morel, B. Palier and J. Palme (Ed.), *Towards a social investment welfare state?* Policy Press, Bristol.

15 OECD, *Policy responses to the economic crisis: stimulus packages, innovation and long-term growth*. DSTI/IND/STP/ICCP(2009)1/ADD/FINAL, 2009 <http://era.gv.at/object/document/398/attach/OECD-0509StimulusPackagesInnovationLongTermGrowth.pdf>

Indeed, since the Commission's pioneering report on the Cost of non-social policy¹⁶, scholars and practitioners across the world have collected highly compelling evidence showing the enormous costs of late policy interventions compared to preventive and early interventions across citizens' lives. Early identification of social risks and early action targeted at the more vulnerable groups contributes to providing citizens with the tools necessary to successfully face the most common social risks (such as atypical employment, poor health, long-term unemployment, working poverty, family instability and poor or obsolete skills).

2.1.2 Specific social investment policies and their macroeconomic implications

We have built the case for the general benefits of social investment at the macroeconomic level. The body of empirical and theoretical evidence with regard to specific programmes and interventions has been growing over the decades. We explore this in three areas – childhood education and care, vocational training and apprenticeships.

Childhood education and care

Affordable childhood education and care (CEC) provides children with the cognitive abilities which will determine their future participation in the labour market and allows mothers to participate in paid work, which, as demonstrated by Esping-Andersen¹⁷ with reference to the Scandinavian countries, is the most effective way to reduce child-poverty and in-work poverty. Chetty et al.¹⁸ demonstrated how the quality of a child's kindergarten teacher and educational environment influence people's probability of college attendance, future income and home ownership. In fact, CEC and education policies are strictly related to active employment policies: "activating or retraining adults is profitable and realistic if these same adults already come with a sufficient ability to learn"¹⁹.

According to Ciccone and de la Fuente²⁰ every additional year of schooling increases European students' future wages by around 6.5%, while a year of training leads on average to a 5% salary increase. Furthermore, from a macro-economic perspective, an extra year of intermediate level education increases aggregate productivity by about 5% immediately and by a further 5% in the long-term. According to Hanushek-Woessmann²¹

16 Fouarge Didier 2008: Cost of non-social policy: towards an economic framework of quality social policies – and the cost of not having them. Report for the Employment and Social Affairs DG.

17 Esping-Andersen Gøsta, *Why we need a new welfare state*. Oxford University Press, Oxford, 2002.

18 Chetty and al., *How Does Your Kindergarten Classroom Affect Your Earnings? Evidence From Project STAR*. BER Working Paper No. 16381, 2011. <http://www.nber.org/papers/w16381>

19 Esping-Andersen Gøsta (2002).

20 Ciccone A. and Á. de la Fuente, *Human capital in a global and knowledge-based economy. Final report for the European Commission*. 2012.

21 Hanushek Eric and Ludger Woessmann 2012: "Do better schools lead to more growth? Cognitive skills, economic outcomes, and causation" in *Journal of Economic Growth*, Springer, vol. 17(4): 267-321.

improving educational standards up to the level of the top performer (Finland) in the EU28 would lead to a 16.8% increase in GDP.

Vocational training

The capacity of a country's workforce to continually update its skills is perhaps the most important factor for future competitiveness in the current globalized learning economy. As demonstrated by Lundvall-Lorenz²², there is a strong positive correlation between the number of high quality jobs and firms' investment in continuing vocational training, while the correlation between high quality jobs and tertiary education or scientific education is weak at best. Even more strikingly, the comparative analysis of statistical data across EU countries shows how there is a fairly positive correlation between high levels of unemployment protection and frequency of high-quality jobs. Finally, income distribution is more equal in countries with high frequency of organizational learning supported by social investment in education and training (as in the Netherlands and Scandinavian countries). Similarly, Nelson-Stephens²³, based on the analysis of data across 17 OECD countries from 1972 to 1999, show that there is a positive correlation between the use of active labour market policies, levels of employment, number of high quality jobs and general economic growth.

Life-long learning and in-job training should be considered an important part of active employment market policy: according to the Commission, "the transition rate out of unemployment to employment is 6 points higher for those having had some lifelong learning opportunities (37 % vs. 31 %), as also mirrored in a lower persistence rate in unemployment (44 % vs. 49 %)"²⁴.

Apprenticeships

In the same way, apprenticeship programmes are very effective for the development of human capital. According to Center for American Progress "researchers have found that U.S. workers who complete an apprenticeship make about \$300,000 more than comparable job seekers over their lifetimes. People who complete a British apprenticeship have been found to make a gross weekly wage 10 percent higher than those who have not. A Swiss study found that employers spend around \$3.4bn annually training apprentices but earn \$3.7bn each year from apprentices' work during training. In Canada, researchers found that employers receive a benefit of \$1.47 for every dollar spent on apprenticeship training. In the United Kingdom, the Department for Business, Innovation and Skills and the National Audit Office determined that for every pound spent by the

22 Lorenz, E. and B. Lundvall "Accounting for Creativity in the European Union: A multi-level analysis of individual competence, labour market structure, and systems of education and training," Cambridge Journal of Economics, Oxford University Press, vol. 35(2), pages 269-294.

23 Nelson, M. and J. D. Stephens 2012: "Do social investment policies produce more and better jobs?" in N. Morel, B. Palier and J. Palme (Ed.), *Towards a social investment welfare state?* Policy Press, Bristol.

24 European Commission, 2013.

government to support apprenticeship, the country gets a return of between 18 pounds and 28 pounds”²⁵.

This brief overview demonstrates that social investment can create substantial future savings and earnings for the state, which would explain its frequent association with public or philanthropic investment.

2.1.3 Private capital in social investment

Is there a case for involving private investors along with public investors in social investment? On the one hand, certain social investment activity is more closely related to the private sector, contributing to its competitiveness. For instance, private investors could be interested in human capital development (upskilling/requalification of workers, better matching between education and work-market needs etc.), and especially considering that, according to a recent PWC survey of Global CEOs, the number one concern of business executives across the world is the inability to find enough skilled workers.

The costs of non-intervention for the safety and health of workers can be very high. According to the ILO, costs of work-related accidents and diseases are estimated to range between the 2.6% and the 3.8% of EU GDP, while for every euro invested in occupational safety and health there is a return of €2.20.

But emerging evidence²⁶ demonstrates how public-private partnerships for investing in social infrastructure, such as schools or hospitals, can generate significant social and financial returns too, both for public and private partners, in line with the Social Investment Package recommendations.

Romanian National Health Insurance Fund²⁷

In 2004 in Romania, the National Health Insurance Fund (NHIF), advised by the International Finance Corporation, contracted four international private dialysis operators to take over the renovation and management of renal services at eight different public hospitals across Romania in order to make the facilities compliant with EU standards. The government paid the private partner a flat fee (€100) per hemodialysis treatment and an annual fee (€11,000) per peritoneal patient. Patients accessed the dialysis services for free. The private partners are responsible for the complete renovation, fitting-out and management of all centres as well as for the recruitment and training of all local staff, and for delivering all services.

At the start of the contract, all centres were located at the public hospitals and the facilities were leased to the private partners. The contract covered an initial four years

25 Center for American Progress, 2015.

26 See for instance OECD, *Infrastructure Investment: Links to Growth and the Role of Public Policies*. Economics Department Working Paper No. 686, 2009 and OECD, *Regions Matter: Economic Recovery, Innovation and Sustainable Growth*, 2009.

27 See IFC, “Contracting-Out Dialysis in Romania: What Was the Impact?”, Monitor, 2008 and IFC, *IFC Support to Health Public-Private Partnerships*, 2010.

and was extendable up to seven years, but only if the private partner relocated to a new facility within two years of the tender award. Each bidder was restricted to two centres to increase competition and limit concentration.

Between 2005 and 2008, the private partners invested over €28.6m to renovate and equip the facilities; additionally, two new facilities opened, with 17 more clinics to be constructed in the future. Further to upgrading its services to EU standards and re-training the workforce employed in the facilities, the government saved €2.9m between 2005 and 2008 as a result of this partnership.

2.2 *Investment in public good*

Definition

We define public good as all those goods or services that create social as well as economic value and have a positive impact on a given community. It is already possible to identify a growing body of successful private or public-private investments.

Social housing, renewable energy, waste and water management, open-source technology – these are all cases where social impact can be associated with positive financial returns.

2.2.1 *The case for public good investment*

Leading businesses recognise that positive social and environmental impact is not only compatible with making profits, but, in the medium term, is a pre-condition of them. They are recognising that they cannot continue to view value creation narrowly, optimising short-term financial performance while ignoring the broader influences and risks that determine their longer-term survival. As Donaldson and Dunfee²⁸ remind us, while in the 1950s enterprises were basically expected to produce goods and services at reasonable prices, now they're considered responsible for a wider range of issues involving fairness and quality of life across their ecosystem of operation.²⁹ Further than adjusting to a changing social contract, companies are increasingly aware of the fact that they cannot overlook the loss of natural resources vital to their operations, the viability of supply chains, or the economic distress of the neighbourhoods in which they produce and sell, without undermining their future activities.

The availability of talent, intellectual property protection, rule of law and neighbourhood levels of employment might be external to the company's perimeter of action, but will have a material impact on its performance in the medium to long-term. As KPMG Global Chairman Yvo de Boer has said, achieving positive economic and

28 Donaldson, T. and Dunfee, T.W. (2002): "Ties that bind in business ethics: Social contracts and why they matter". *Journal of Banking and Finance* 26 (9): 1853-1865.

29 Although of course this not always the case, and deregulation has allowed opportunistic behaviour by companies. On the topic see Sangheon Lee and D. McCann (eds), *Regulating for Decent Work. New directions in labour market regulation*, Palgrave Macmillan, 2011.

social impact is not a philanthropic act, but “is essential to convince investors that your business has a future beyond the next quarter or the next year”³⁰. These considerations are leading towards increasingly sophisticated business strategies allowing to associate economic performances to positive social impact.

On the other hand, impact investing is increasingly becoming a privileged choice for all those citizens, philanthropists and third sector organisations who choose to create positive social outcomes as well as financial returns.

Of course the risk is that large companies, driven by a mixture of self-interest and regulation, will identify sustained profitability with the management of external social risks, and take measures to engage the political environment. The public and third sector will need to identify and denounce opportunistic behaviours and, by encouraging transparency, help companies to validate their results and demonstrate genuine attempts to achieve social impact. In this respect, the forthcoming Commission strategy to combat tax fraud and evasion will be key. On the same line, social impact is not always achievable through economically self-sustaining business models, and it is important to make sure that impact investing won't take away vital resources from the third sector.

In spite of these concerns, corporate social responsibility and impact investment are indeed contributing to create a new market where private and public interest are aligned, and financial and social returns go hand in hand.

2.2.2 Public good investment in practice

Impact investment

One specific category of investment in public good is impact investing, which we define as the field of investment that takes into consideration social impact, financial return and trade-offs between them in any investment opportunity. Over the last decade, it has become a new driver of investment in the public good through the actions of charitable foundations, ethical banks, individual philanthropists and specialist impact investment funds. Not only has impact investment brought new funds into organisations targeting social and environmental objectives, but it has also led to the creation of innovative public-private models of investment and has attracted the attention of policy makers across Europe and beyond.

Data on the size of the impact investment market, on the risk profiles of investments and on financial and social performance is hard to find and even harder to compare³¹. Work to increase transparency and data comparability continues. Interest from investors is growing. According to JP Morgan the market was worth \$12.7bn in 2014 and is growing fast. As an indicator of the rise of impact investing, BlackRock, the world's largest asset manager, has announced that it will soon launch “BlackRock Impact” to help clients invest in products with clear environmental and societal goals³².

30 *The KPMG Survey of Corporate Responsibility Reporting 2013.*

31 OECD, *Social impact investment. Building the evidence base*, 2015.

32 See <http://www.reuters.com/article/2015/02/09/us-blackrock-impact-exclusive-idUSKBN-oLD18W20150209>

Global Health Investment Fund³³

The \$108m Global Health Investment Fund (GHIF) was launched in 2012 by the Bill and Melinda Gates Foundation and Grand Challenges Canada with the aim of accelerating the development of drugs, vaccines and diagnostics for diseases that disproportionately affect developing countries.

The fund has received direct investments on a pari-passu basis from foundations, high net worth individuals, government supported bodies and corporates. The Gates Foundation, together with the Swedish International Development Agency (SIDA), has substantially reduced the risk for investors making direct commitments to the fund by providing a first loss guarantee and a risk share (investors are provided with a loss protection of up to 60% of the fund's capital, the first loss guarantee covers up to 20% of invested capital, with investors covering 50% of any subsequent losses on a pari passu basis).

The Gates Foundation has also leveraged its network and expertise to assemble support from a range of global health and finance experts: representatives from GlaxoSmith-Kline and Novartis, two of the world's leading pharmaceutical companies, and former leaders in the field of finance from Goldman Sachs and MPM Capital are serving as members of the board of directors and scientific advisory committee.

Funding is provided through mezzanine debt and repaid via a combination of milestones and royalties on the new products created. So far, \$5m has been committed to support the final stages of product development for a new oral cholera vaccine.

Social impact as business as usual

The idea of creating social impact is increasingly important for large businesses' principal activities and financial decisions. As highlighted by Michael Porter and Mark Kramer³⁴ in their seminal work *Creating shared value*, the "generation of long-term sustainable returns is dependent on stable, well-functioning and well governed social, environmental and economic systems (...) effective research, analysis and evaluation of ESG [environmental, social and corporate governance] issues is a fundamental part of assessing the value and performance of an investment over the medium and longer term, and (...) should inform asset allocation, stock selection, portfolio construction, shareholder engagement and voting."

A few examples showing both how social considerations are influencing financial decisions in the corporate sector and how investment in public good can be financially rewarding can be found in the urban regeneration field.

33 See <http://ghif.com/>.

34 Porter, M. and Kramer, M. (2011). "Creating Shared Value". HBR. January 2011.

Lend Lease: urban regeneration

Lend Lease is currently investing £1.6 bn in a regeneration project covering more than 28 acres across three sites at the heart of Elephant & Castle, in what is one of the last major regeneration opportunities in central London. By 2025, the regeneration project foresees the creation of almost 3,000 new homes, over 50 new shops, restaurants cafes and bars, as well as significant improvements to transportation links. The approach adopted by Lend Lease is innovative both at environmental and social levels.

From an environmental perspective, Lend Lease's sustainability approach is long-term and aims to enable sustainable behaviours, such as enhancing biodiversity, improving public transport and cycle networks, and maximise the energy-efficiency of buildings. The plan was influenced by community consultation so that many of the existing trees on the site could be kept to help form a brand new park in the centre of the development. Many more new trees are then being planted in and around the development, and the diversity of tree species chosen will help create balanced ecosystems that are more resilient to extreme weather as well as encouraging nature to flourish. In addition, Lend Lease seeks to ensure that all the wood used on the project is FSC certified and all homes on the scheme will achieve Code for Sustainable Homes Level 4.

The high-standards adopted in terms of sustainability are further proved by the fact that the Elephant & Castle regeneration is one of 18 founding projects from across the world to be part of the C40 Cities Climate Positive Development Programme (both Lend Lease's Barangaroo South and Victoria Harbour are also included). As part of this programme, Lend Lease has submitted a roadmap demonstrating how the project will be Climate Positive, or net carbon neutral, by 2025. A key part of this commitment to being Climate Positive, is Lend Lease's plans to deliver an on-site combined heat and power energy centre, which will help ensure a low carbon energy solution for the project. By demonstrating climate-positive strategies, the project aims to be a model for large-scale urban regeneration projects of the future.

As for social considerations, the commitment of the firm is demonstrated by the fact that in the time lapse between the award of the contract to Lend Lease and the granting of outline planning approval, £2m was invested into community-engagement activities. A strategic stakeholders group was set-up with key public authorities such as Transport for London and the Greater London Authority, as well as local universities and other developers in the area in order to ensure a coordinated approach through the opportunity area.

A thorough assessment of local social issues (unemployment, low-income, mental health, obesity, children's health) served as a basis for the project's social sustainability strategy. A key part of this strategy is the delivery of construction jobs for the local community and the project is already achieving great success. Since construction began in July 2013, 322 local residents have been employed on the project, of whom 147 were previously unemployed. Among them, 55 have been in sustained employment for more than 6 months. Furthermore, in 2012, a community fund to be managed by a local NGO was set-up to provide grant-funding for local community groups looking to run

projects in the area; the fund is now in its fourth year and has awarded over £125,000, benefitting 6,950 people.

Re-Vive: the Ekla project

In Brussels, the Ekla project aims to decontaminate and redevelop a 6,200sqm former industrial zone in Molenbeek, next to the city's West station, to become one of the three most important intermodal hubs for public transportation in Brussels.

Belgian company Re-Vive, specialized on urban brownfield sites development, has allocated €32m to build 45 apartments for affordable housing (to be built by the public local supplier Citydev), 39 apartments for social housing, 50 student housing units suited for students in need of financial support, a primary school, day nursery, retail spaces and a social innovation hub and offices. Once completed, the buildings will be sold to end investors (impact investors or social funds). To this end, Re-Vive has been working together with regional investment agencies and funds such as Citydev (Brussels) on the affordable housing front, or Vlaamse Gemeenschapscommissie (Flanders) for the school. The neighbourhood is characterized by both poverty and unemployment, with a large immigrant community; however, its inhabitants are also young and very entrepreneurial: the social innovation hub will build on this potential by offering not only office space, but also business support. The use of the building as a hub for cultural events and exhibitions before the opening of the construction-site allowed Re-Vive to establish a trusted relationship with local artists, who acted as intermediaries with the local community, which was instrumental to attract the attention and support of local authorities. The buildings are designed with sustainability in mind: maximising the use of renewables and reducing energy consumption.

The Lend Lease and Re-Vive examples illustrate two key success factors in their implementation: strong relations with local authorities and strong partnerships with local communities and stakeholders.³⁵ In the Re-Vive case for instance, City councils and local authorities have been instrumental in fostering projects' economic sustainability by facilitating swift zoning of the areas concerned from industrial to commercial or residential use. Furthermore, in response to the projects' strong social and environmental aspects, more building density has been allowed than usual, granting increased revenues.

Re-Vive's approach aligned well with most local authorities' policies for open development, and contributed to further growing policy-makers' ambitions in the urban re-generation field. Residents of the neighbourhoods targeted by both development projects were involved at very early stage in order to take into accounts their needs, views and aspirations. Before being refurbished, buildings were used as temporary meeting centres, in order to engage with the local population and explore its cultural and crea-

35 Of course this leads to a risk of collusion, for this reason transparency in tendering procedures and community engagement all along regeneration projects are key. On the topic see Anna Minton, *Ground Control*, Penguin Books, 2012 and the seminal work of Jane Jacobs, *The Death and Life of Great American Cities*, New York: Random House and Vintage Books, 1961.

tive strengths through a series of events. Local partners (including public authorities) are always involved when social housing programmes are foreseen.

In both cases, economic reasons fully justify a socially responsible approach: in fact regeneration projects strongly impact the cost of housing: mutated costs of leaving can mean raising inequality, compromised social cohesion and, therefore, increased systemic risks for the value of assets. Creating a community instead of a series of buildings, and making sure that regeneration brings advantages to the local population, means reducing the project risk while ensuring the long-term value of the real estate. In addition, it creates interest, and therefore market for future buyers and users of the new buildings and facilities.

3. A glimpse to the future: Investment in systemic social innovation

We define systemic social innovation as the collective effort to face entrenched social issues through the coordinated action of the public, private, third sector and of citizens at large³⁶.

Today most social issues (for instance poverty, social exclusion, quality of health care) and macro challenges (such as aging, climate change, the sustainability of welfare systems) interlink with one another and drive a cycle of deprivation. Social ills cannot be faced one at a time, in isolation, by adopting single points of intervention. For instance, if we want to increase educational attainment in a neighbourhood – or in a country – the question is not simply one of whether more funding should be allocated to public schools or to private schools. It is necessary to map and intervene in multiple factors affecting education in the area, such as investing in prenatal nutrition, establishing breakfast clubs to increase children's attention spans, setting reading clubs to mentor pupils, mums' associations to support young mothers, youth circles to provide peer support and developing new tech to facilitate communication between parents and teachers.

This means that we need a new approach, where the public, private and third sector and citizens at large can come together to understand how to face entrenched social issues in the most effective way by co-designing, co-funding, co-delivering and co-evaluating innovative solutions.

The case studies in the preceding chapter show us that the most successful experiences – both financially and socially speaking – are those where a strong partnership has been created between the public and the private sector (including third sector organizations) and involving the wider community; not only in terms of the funding model but also in terms of the design, delivery and evaluation of the good/services produced. In this chapter, we argue that – complementing the need to apply a more social lens to

36 Social Innovation has been mostly intended as new services or products answering unmet social needs, and often identified with social enterprises. This is for instance the case of the Commission's EuSEFs regulation, where social entrepreneurship funds' investees need not only to be social enterprises, but also have to serve particular "deprived groups" instead of the wider population. We call instead for system innovation, i.e. for a comprehensive approach taking into account positive and negative feedback effects and non-causal relations across fields and sectors.

initiatives like EFSI – all social stakeholders would do well to adopt a collaborative approach to drive innovation in society at a systemic level. We illustrate this approach with case studies and an outline of the current work of EuropeLab/SmallWorldLabs.

3.3.1 *The partnership of public and private*

If we look at what is happening across Europe, we will find that increasingly member states are looking with interest at how to create better welfare services (especially on the social investment front) by actively collaborating with the private sector, the third sector and citizens at large. In contrast to what was observed in the 1970s when, following Hemerijck³⁷'s classification, in the wake of oil shocks, Europe entered a period of welfare retrenchment and of slimming down the state, the aim today cannot be about the outsourcing of key services – instead it must be about collaborative shared value creation.

The awareness of the tremendous social and economic challenges facing most European countries, together with the awareness – accelerated by the financial crisis – that the public sector is unlikely to have the resources necessary to meet these challenges, has galvanized efforts which were already on-going within the private and third sectors.

The rise of impact investing, the growth of social enterprises, the professionalization (concerning forms of governance, management and ways of production) of third sector organizations and a growing community of traditional businesses committed to making a positive difference to their social and environmental surroundings has led to the creation of a complex ecosystem of actors committed to using their different skills and networks to overcome entrenched social issues.

Unisalute

In Italy UniSalute – a specialist company owned by Unipol Group, the biggest Italian insurance group for number of clients served and the second in terms of premium disbursement – is working to set-up a local fund in the Emilia Romagna region with a specific focus on Long-Term Care (LTC). The idea is to pool resources from the public sector (allocated locally by the National Health Fund), the private sector and from single insured citizens in order to create synergies allowing the successful meeting of social needs by extending to all citizens LTC services already provided by the insurer to its existing clients.

The growing demand for long-term care services in Emilia Romagna has not been met by the national health sector, and in 2011 for the first time public funding for the elderly in the health sector was cut by 2.4% compared to the previous year, with home-care services particularly affected by the cuts (-7.9%). The situation is quickly becoming unsustainable, and especially if we consider that around one third of the total expenses for elderly-care in Italy is already paid for by families. Furthermore, LTC services are currently provided by a plethora of municipal, regional and local authorities, with little coordination and without certainty regarding the availability of services, as public

budgets can vary widely over the years. This translates into a situation of uncertainty for people in need of assistance, who therefore will in most cases access emergency services, leading to unnecessary hospitalisation and increased costs for the public sector.

A local, or even better regional fund targeting people in need of assistance who could be treated at home and covering in a coordinated way all their socio-sanitary needs, pooling resources from the private and public sector and integrating the different services needed while coordinating the various service providers, would allow this challenge to be addressed in a sustainable way.

The fund would be built pooling public resources (co-funding for low-income households or fiscal deductions) and private resources (work insurance or private insurance), and the insurance company would grant services' continuity over the years. By allocating part of the funds available for people in need of constant assistance to the fund, the public sector would transform current expenses into an insurance investment, granting coverage continuity and allowing the fund to reach the critical mass necessary to extend services to everybody (including the unemployed or people not enjoying insurance coverage negotiated by employers and trade unions).

The model put forward by Unisalute would allow considerable savings for the public sector: against an initial fixed investment the insurer will grant universal assistance to all citizens in need, irrespectively of their number. Citizens would also benefit from the partnership, given that at the moment about one third of the total expenses for LTC are borne directly by families. The model is sustainable for the private partner too, thanks to efficiency gains allowed by its negotiating power on the market: Unisalute can already count on a network of over 4.669 structures specialized in providing assistance to non-autonomous people, meaning that it can ensure highly convenient tariffs by purchasing packets of services instead of single services (which is not the case either for the public sector or families).

Most importantly, the quality of the service provided would be higher. The private insurer would not only manage the fund but would also exercise a pro-active role in coordinating services delivery. Building on its existing network, Unisalute would act as a single entry-point for beneficiaries through a network of in-house case managers, developing individual assistance plans (IAP) for the beneficiaries and their families which would take into account their medical, social and economic needs. The network of case managers, distributed on the territory, will ensure coordination between service providers and constant monitoring of the quality of service through regular contact with the assisted person and her/his family.

The public sector will maintain ultimate control on the service's quality and cost-effectiveness, through audits and a relationship of total transparency with the private partner.

The capacity of national authorities to direct and coordinate these efforts varies hugely. The strategy recently put in place by the UK government to promote impact investing is particularly interesting. By collecting and publishing the costs of social issues (as vio-

lence on women, re-offending or hospitalization), the government is encouraging third parties to come up with new and more cost-effective solutions in determinate fields.

New forms of commissioning too, such as payment-by-results (or pay-for-success), allow the testing of new services – for instance, those that the public sector would be unlikely to fund independently and by itself but which, if proved effective, could become part of mainstream services. In this case third sector and private organizations can offer services to address unmet needs.

3.3.2 Systemic social innovation in practice

There is no single institution or policy that can effectively address social ills, which is why a collaborative and systemic approach is needed. EuropeLab/SmallWorldLabs is already piloting this approach in several European countries. Our starting point is the recognition that citizens – as well as private organizations and institutions – are both a repository of collective common wealth (or assets) and of common liabilities (current and future), and that both are largely quantifiable in terms of current and future value and related costs, savings and returns. Mapping the different issues affecting a specific community, their various components and often interdependent relations, the stakeholders concerned and the possible solutions which can be put in place, means organizing new inter-sectorial and inter-organisational partnerships, developed around shared outcomes. We call these partnerships “collective outcomes partnerships”.

Assessing the value of available goods and services of public interest for all the stakeholders involved in the partnership, as well as the costs associated to maintaining, scaling-up, adjusting or replacing those same goods/services as required by a changing situation, allows-us to build new funding and action models to drive systemic development. We call these ‘Townhall Models’ because the underlying approach puts civic engagement at the centre of local and national development, building on systems financing and accelerators. The public sector plays a key role in promoting the creation of these complex partnerships, as in the case of the Portugal Social Innovation Initiative.

In this case, public funding is being used not only to catalyse private funding in order to find effective solutions to entrenched social issues but, most importantly, to build “collective outcomes partnerships” in which co-funding is accompanied by co-design, co-delivery and joint monitoring of the good and services which are instrumental for achieving the agreed outcomes. We believe that this new model of public-private funding will be instrumental in tackling inequality and re-establishing long-term growth in Europe. For this reason we recommend the Commission to make sure that not only impact investing funds are considered eligible under EFSI (on an equal footing with European long-term investment funds), but also that their scope is not limited to funding social enterprises and encompasses more ambitious “systemic social innovation” projects to be undertaken in partnerships with local, regional and national authorities and all interested parties.

Portugal Social Innovation

In Portugal, the Council of Ministers launched in early 2015 a Social Innovation Initiative which will make available €150m from European structural funds to promote and disseminate innovative solutions to tackle social problems leveraging creativity, entrepreneurship and civic participation in the country. The initiative was created with an ambitious agenda to modernise the country's social protection, education and regional development systems and promote sustainable and inclusive growth through the growth of social innovation projects.

Incentives are being put in place to reward those investments that provide social and environmental returns as well as being able to generate revenues and financial surpluses, while citizens, businesses and communities are called to experiment innovative solutions and, in so doing, renew public policies. Four strands of financing instruments are being set-up: 1. a fund of funds providing guarantees and low cost-funding, both for lending and quasi-equity investments in high- impact potential projects that can generate revenues; 2. a social impact bonds fund to develop and validate the payment-by-results approach in Portugal and so doing fostering collaboration between public, private and social sectors and serve as an engine of innovation for public services delivery; 3. a “partnership for impact program”, providing co-financing grants to philanthropic investors willing to fund the most innovative social impact initiatives using a venture philanthropy approach; and 4. A social investment readiness program to build capacity and grow the pipeline of projects for the other three instruments.

Quoting a recent interview to Luis Miguel Poiars Maduro³⁸, Minister in the Cabinet of the Prime Minister and for Regional Development and promoter of the initiative, Social Innovation Portugal aims at overcoming austerity and fiscal consolidation policies by sustaining the creation of a “true civic economy”, focused on achieving social impact while reaching economic sustainability across sectors and geographical and organisational boundaries. The idea is to turn “public costs” into shared investment for the common good, encouraging the shift from the provision (or the purchase) of social services by the public sector or – to a lesser extent – philanthropic entities, to the co-design, co-financing and co-delivery of social outcomes agreed by all the stakeholders involved.

Conclusions. Growing social and public good investment: recommendations for EFSI

Evidence shows that unless we are able to reduce inequality and invest adequate resources to enhance and modernise European welfare systems, we will not be able to re-ignite long-lasting growth.

As we have started to see, there is not necessarily a trade-off between social and environmental impact and economic performance. Taking into full consideration projects' “societal” returns would certainly contribute to make EFSI's investments more valuable for society at large, while not undermining their profitability and therefore their attrac-

38 See Cadorin, L., Impact Investment. La sostenibilità necessaria. Corriere della Sera Economia – Dossier. 23 March 2015.

tiveness to private investors. Most importantly, the new Commission investment plan could induce positive change in the way investors take decisions and projects' proposals are structured, leading to more socially and environmentally sustainable financial markets. To achieve this, investments in public good, systemic social innovation and social investment should be promoted under EFSI, and every project funded, including "hard-infrastructure" projects, should be evaluated also for their social impact.

In order to achieve this, we recommend the following:

"Societal value" in the new investment strategy has to be clearly spelt out, aligned with consolidated practice, and implemented in every investment decision.

- a) Ensure that the "societal value" is properly weighted in the projects' evaluation grid (e.g. by assessing infrastructure projects' also in terms of local work-force upskilling, new jobs created, related RDI activities, smart specialization, partnerships with local actors etc.)
- b) Ensure that at least one member of the Independent Expert Committee has specific expertise in evaluating social impact and that each member of the Independent investment Committee is provided with detailed information on the importance of taking into account the "societal dimension" of every project.
- c) Ensure that the Investment Advisory Hub includes social investment and impact investing experts to provide guidance on how to evaluate societal impact and build effective public-private partnerships for social investments and investments in public good.
- d) Ensure that a share of the available funding resources are allocated for social investments and investments in public good as ends in themselves and not just as a complementary investment to hard infrastructure. This can be achieved by ensuring that the "Investment Task Force" in charge of identifying strategic investment projects across member states includes experts in social investment and investments in public good.

Public and private funding streams have to be aligned within the new investment framework.

- a) EuSEFs funds and other impact investment funds such as the EIF backed Social Investment Accelerator (SIA), recently re-capitalized with €610m (and a further €300m is in discussion with the EC) should be among EFSI's investment options and on an equal footing with ELTIF funds. Broadening the scope of the definition of social undertakings under the EuSEF regulation review (due in 2017) will be of the utmost importance in order to ensure the take-up of the label by impact investors and the quality and ambition of projects funded.
- b) Private impact investing funds should be considered investible vehicles, and projects dealing with systemic social innovation should be encouraged with higher scores in the "societal value" assessment.
- c) Impact funds capitalized through structural funds such as the recently launched Portugal Social Innovation Initiative and the Key Fund already operating in the North East of England offer viable opportunities to align the new strategy with cohesion policy, leveraging structural funds.

ANNEX

Quantitative Easing, structured finance and support to the real economy.

Proposals on Asset Backed Securities (ABS)¹

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1. Introduction

The banking regulation CRR/CRDIV has made European banks stronger and more resilient. However, the capacity of banks to lend is being weakened by the adjustments to the new regulatory framework and the balance-sheet repairs still on-going in many parts of the European banking system. The lack of credit is now confronting even sound businesses in some parts of Europe and is making the continent's economy weaker. It weighs on its recovery. In the short term, improving the Eurozone banks profitability is not feasible.

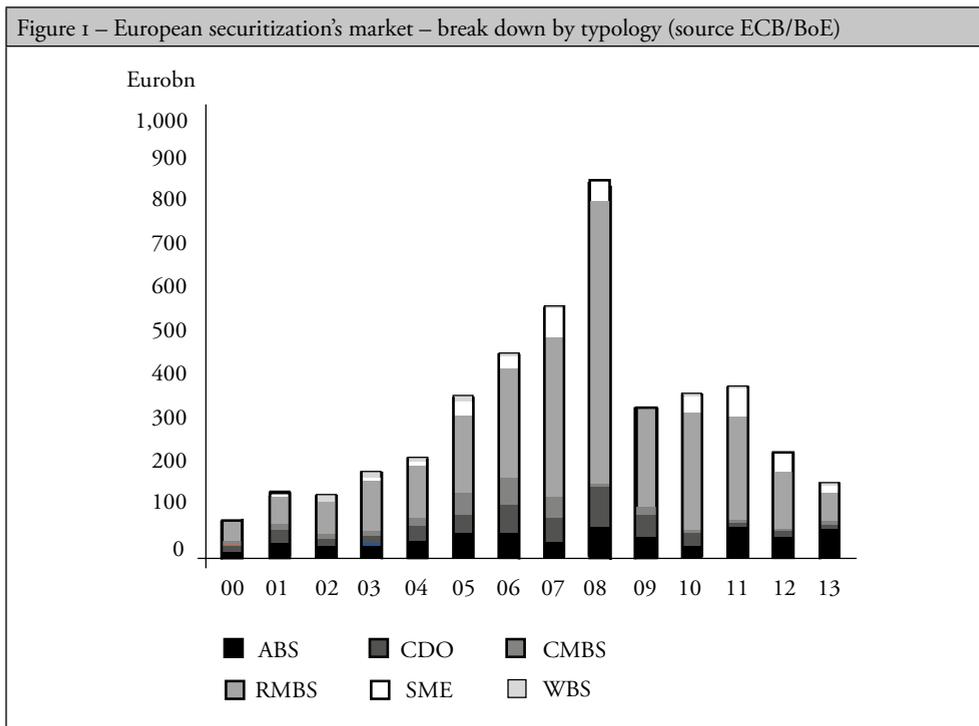
Thus, the market supply of new capital is low. Moreover, banks tend to reduce assets, including loans, in order to satisfy the targets imposed by the new regulation related to liquidity and capital ratios.

One way for firms is to gain direct access to financial markets through equity or bond instruments. However, these options are not always available, especially for smaller size firms and are time consuming.

An appropriate answer for such companies is to revitalize the market for securitized loans, in order to support bank lending. However this market, which never really took off in Europe before the crisis, has all but vanished since the financial crisis (see Figure 1).

¹ The opinions expressed in this paper are exclusively those of the authors and do not necessarily reflect the views of the Institutions to which they belong.

This paper is a work in progress so comments are very welcomed at this stage. Many people and institutions have discussed this preliminary draft of the paper and given us important insights. We wish to thank the participants to the Astrid Working Group as well as Alberto Gallo (RBS), Silvia Ghielmetti (CRIF), Massimiliano Rimarchi (EBA), Fabrizio Sadun (Unicredit) and Alessandro Settepani (LIUC).



The securitization of loans, if properly structured and regulated, represents a bridge between banking and market funding and can integrate other long-term funding sources (long-term wholesale) for the economy, in particular SMEs. In fact, as briefly discussed in the Annex, Asset Backed Securities (ABS) not only create new sources of funding, but also free up capital in banks' balance sheets to make new loans. In this macroeconomic context ABS could therefore become an eligible candidate to effectively transmit to the real economy the non-conventional policy measures adopted by the European Central Bank. In revamping the securitization market it is crucial to avoid the mistakes of the past. This implies well designed guidelines on the quality of the underlying loans and simple and transparent structuring techniques. One of the most interesting recent proposal to revitalize the securitization market – focusing on the quality of the underlying loans – was elaborated by Eurofi (September 2014). The idea is to restrict, in a first phase, ABS to loans that have a default probability lower than 0.4% over 3 years (so-called Prime High Quality Securitizations – PHQS).

The proposal is based on a research made by the Banque de France (which also rates SMEs loans), according to which the number of loans to French firms with default probability over three years (<0.4%) is approximately 40,000 for a total amount of over 150 billion of euro.

Such a criterion is more stringent than the one currently required by the ECB for loans eligible as collateral (one-year default probability $\leq 1.5\%$) and should therefore contribute to improving investor confidence in ABS.

The proposal, however, as we shall try to argue in this paper, would have no significant systemic effect on many of the Eurozone Member Countries (MCs). If ABS are restricted to PHQS, in fact, what would be the eligible amount of issues in many of lower rating Eurozone MCs, and, in particular, in Italy? Also, what would be the incentives for banks, especially in terms of cost of capital, to transfer (securitize) loans from their high quality portfolios and replace them with potentially lower quality loans?

In Italy, for instance, historical data show that loans to firms only meet the criteria required by the ECB on the quality of collaterals and therefore the structuring of PHQS would include potentially very small amount, if any, of ABS issuing. Moreover, given that the sale of assets through securitization should reduce the risk (and its weighting) for the originating banks, ABS would improve capital ratios and reduce the leverage. To make ABS attractive for European banks, a proper re-calibration of the risk weights of CRR/CRDIV is needed at least in terms of consistency².

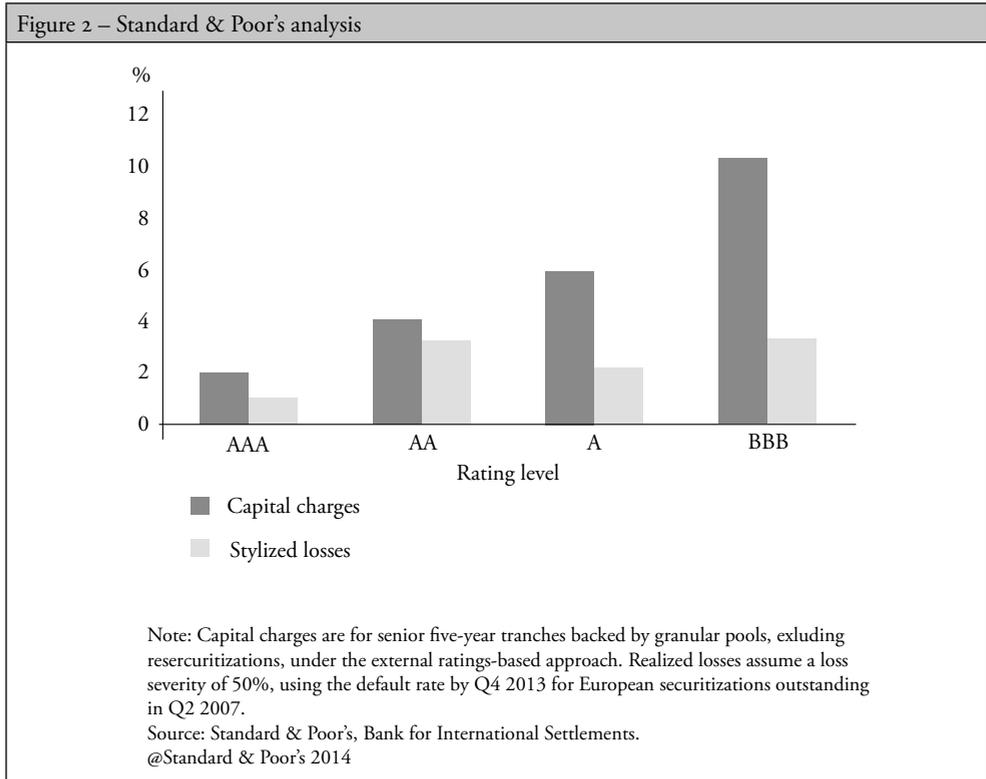
In particular, regulators could work on the asymmetries between ABS and collaterals as far as their the risk weights treatments are concerned³.

Based on very conservative assumptions on default rates, S&P estimates that a “AAA” tranche of securitized loans would absorb regulatory capital equal to twice the expected losses⁴ (see Figure n. 2).

There is currently a broad consensus among experts (but now also among regulators and policy makers) that, under the current rules, there is no “fair” correlation between capital requirements and the actual underlying risk of the securitized loans. Therefore, it is reasonable to expect regulatory re-calibrations⁵.

This should give further boost to the European Central Bank’s decision of 4th September 2014 and the statements of the President Draghi, recently reiterated at the press conference in Naples on October 2nd, 2014.

- 2 In November 2013, Yves Mersch, Member of the Board of the ECB, openly criticized the lack of consistency of prudential regulation in the treatment of asset-backed securities with respect to the underlying loans of equal rating, comparing it to “calibrating the price of flood insurance on the experience of New Orleans for a city like Madrid.”
- 3 According to the current Standardized Approach, the risk weight for “A” rated ABS senior tranches is equal to 6%, compared with 4% for loans to firms with the same rating. Asymmetries increase for lower quality securities, as “BBB” rated ABS are subject to a risk weight of 10.4% compared with 8% for loans to firms with the same rating. Apparently, these differences are mainly due to the lack of liquidity on ABS market as a result of the financial crisis in 2008 (source: Bruegel, 2014).
- 4 To calculate the “stylized” losses, S&P assumes a “loss severity” of 50% and applies the default rates observed in the fourth quarter of 2013. According to the ECB, the range of default rates of ABS in Europe since the financial crisis (2007-08), is on average equal to 0.6-1.5%. In addition, the Central Bank states that, in Europe, the default rates on ABS having loans to SMEs as underlying are far lower than those of all kinds of securitizations, with a default rate of about 0.1%.
- 5 Recently, two new EU Commission’s Delegated Acts were issued in order to mitigate the liquidity coverage ratio for banks as well as for the implementation of the Solvency II Directive for insurance companies. Both Acts are aimed at relieving the regulatory treatment of ABS.



2. *The asset backed securities program within the ECB Quantitative Easing: analysis and proposals*

On 4th September 2014, the European Central Bank (ECB) announced a set of unconventional monetary policy measures (Quantitative Easing or QE) which include, among other things, the purchase of “simple and transparent” as well as of “high quality, mezzanine guaranteed” Asset Backed Securities (ABS).

In its statement, the ECB made it clear that loans granted outside European borders would not be eligible for “packaging” into ABS, and this in order to prevent that any Eurozone country could attempt to revert on the Euro system potential risks arising from loans granted outside Europe⁶.

From a subsequent decision⁷, it can be argued that the high quality level defined by the ECB as eligible collateral can be associated to a rating⁸ equal to or greater than “single A”⁹.

6 In some cases, like Germany, these loans account for almost 60% of the total.

7 ECB decision n. 278/23 of 20/9/2014, § 4.3., lett. a.

8 Refer to section 6.3 of Appendix I of ECB Guidelines 2011/14.

9 “single A” rating is equivalent to a rating of at least “A3” from Moody's, “A-” from Fitch and/or Standard & Poor's as well as “AL” from DBRS.

Operators are still waiting for a clear definition of what the ECB considers as “simple, transparent and mezzanine guaranteed ABS”. While waiting for further instructions from the ECB, the market is currently assuming, also on the basis of informal statements¹⁰, that:

- “mezzanine guaranteed” means a tranche with a guarantee, arguably even public, as close as possible to a “single A” level;
- “simple, transparent” means that structures which carry double or triple “wrappings” cannot be considered as eligible.

As widely known, the different Eurozone countries exhibit an heterogeneous riskiness highlighted by the spread on their Sovereign bonds. Currently, sovereign ratings range from “single B” for Greece to “triple A” for Germany.

A government guarantee on the mezzanine tranche is therefore expected to produce very different outcomes. It can uplift (upgrade) the quality (riskiness) of the underlying credit portfolio at best at the same rating level of the MC which provides the guarantee. This implies that mezzanine tranches can be potentially structured with “single B” rating in Greece, a “triple B” rating in Italy and “triple A” rating in Germany.

Each country will decide the scope of the guarantee by identifying the risk share of the underlying credit portfolio that it is willing to bear (risk appetite) – i.e. the maximum loss it is ready to write on its public books in case of default of the ABS structure up to the guaranteed mezzanine tranche level.

In this perspective, a Sovereign State could not use leverage indefinitely but should calibrate the scope of its intervention by issuing guarantees consistently with its total debt level.

Nevertheless, to the extent that – by appropriate structuring – the junior tranche will ensure first loss absorption, the government guarantee will become contingent and therefore it should not weigh on its public budget (not included in public debt and/or deficit level).

Hence, the risk appetite will be based on the overall level of risk associated with the MC’s rating. For example, for a credit portfolio of rating quality “double C”, a Greek Government’s guarantee will produce a maximum risk appetite enhanced by two notches (from “double C” up to “single B”). This implies that Greek government may opt to limit its guarantee up to “triple C” or a maximum upgrade up to its sovereign rating level of “single B”. *Mutatis mutandis*, for Germany, the maximum risk appetite would be seven notches (from “double C” up to “triple A”). This obviously allows “triple A” MCs to have a much wider scope when structuring ABS.

The risk appetite of the guarantor will determine the effective amount of liquidity and capital release that ABS produce in banks’ balance sheets.

The risk appetite, the sovereign rating of the guarantor, and the credit quality of the loan portfolio, qualify the financial engineering of the ABS and thus the allocation of risks across the various tranches.

From what stated above and given that the credit quality of a specific loan portfolio tends to be better in countries with higher Sovereign rating, it becomes evident their advantage in structuring high quality ABS.

¹⁰ See ECB’s President (Mario Draghi) Speech of 22/9/2014 and his statement: “...As for the guaranteed mezzanine tranches, their intrinsic credit risk would be comparable to that of the guarantor, be it a national or supranational entity....”.

An attempt to level the playing field among the different Eurozone MCs can be found in the ECB measure if guarantee issues by a supranational entity would be considered¹¹. It is clear that the potential patronage offered by a guarantee issued, for example, by a “triple A” supranational entity such as the European Investment Bank (EIB), alongside that issued by each national Government, is likely to significantly improve both the rating of the mezzanine tranche as well as the potential risk appetite of the guarantor country. But at the moment we cannot count too much on this possibility.

Finally, we do not know how many ABS the ECB intends to buy. It is, however, reasonable to assume that, as far as the guaranteed mezzanine tranche is concerned, the ECB will act as for collateralized loans on a pro-quota basis, linked to the size and the riskiness of each Eurozone MC.

It would therefore be simplistic to assume that, through a government guarantee, MCs with Sovereign rating below “single A” would be able to structure ABS for indefinite quantities whose senior and mezzanine tranches could be sold under the ECB program, thus avoiding the risk of selling those tranches on financial markets.

In conclusion, MCs with sovereign rating below “single A” will have to consider all the possible guarantee schemes in order to maximize the amount of the credit portfolio that can be securitized under the ECB program, considering that these kinds of transactions may significantly contribute to mitigate the credit crunch as well as to reduce the current gap among Eurozone Countries with different sovereign ratings.

3. The structuring of a guaranteed abs: the italian case

In this section, a few possible ABS schemes with underlying assets rated from “double C” to “double B” are proposed. The schemes are assumed considering the Italian case (sovereign rating “triple B”) as a reference country. It is assumed that all the tranches (with the exception of the junior one) are bought by the ECB or by institutional investors in the case of a government guarantee on the mezzanine tranches; moreover, the guarantee can be autonomous or co-guaranteed by the EIB¹².

In our case the junior tranche is bought by the bank that sells the ABS credits portfolio.

The junior tranche is engineered to result lower in magnitude than that one belonging to an ABS with an unsecured mezzanine tranche. As a consequence of this risk transfer a reduction of the junior tranche yields can be assumed, providing benefits, in terms of the overall riskiness, to the ABS capital structure.

The junior tranche could also be acquired by a third subject that would play the role of a bad bank. But we will not consider such a possibility here.

The simulations that follow are an attempt to frame an ideal matrix for different situations which characterize the Eurozone countries.

11 Refer to ECB’s President (Mario Draghi) Speech of 22/9/2014 and his statement: “...As for the guaranteed mezzanine tranches, their intrinsic credit risk would be comparable to that of the guarantor, be it a national or supranational entity...”.

12 The data used in the following examples come from recent reports of Rating Agencies and from other official sources. All the results contained in this paper are provisional and subject to changes and revisions.

Italian institutional investors hold more than half of the “triple B” rated government debt securities. This portfolio is not risk-free: for example, investing in a 5 year BTP implies theoretically a 7% probability of losing more or less half of the capital invested. From the point of view of institutional investors, this higher risk widens the range of admissible investments, since a BTP and a structured product that shows the same loss probability are financially equivalent.

The guaranteed mezzanine tranches embed a risk similar to government bonds which implies that institutional investors could replace a rather “small portion” of government bonds in their portfolio with these ABS notes (“substitution scheme”). Obviously, the structure of the guarantee should be designed to assure that the management of risks underlying the government bonds will be dynamically aligned with those of the mezzanine tranches.

Given the bid-to-cover level at Italian government bonds’ auctions over the last two years, it is reasonable to assume that the market is able to absorb the government bonds released by the “substitution scheme”.

Moreover, our proposal takes into account the need for adequate liquidity provisions to deal also with the residual part of senior tranches that potentially will not be purchased by the ECB nor by institutional investors that could adopt also for the senior tranche the “substitution scheme”.

3.1 Structuring of a government guaranteed ABS with an underlying portfolio composed by low quality assets

The structuring of a government guaranteed ABS with an underlying portfolio composed by banking loans rated “double C” includes a government guarantee on the mezzanine tranche. The government is characterized by a risk appetite of 30%; consequently, the originating banks are expected to buy the re-dimensioned junior tranche equal to 12%.

Given the above hypothesis, the resulting structure (base 100) is the following:

Junior 12
Mezzanine (BBB) 36
Senior (A) 52

The risk of the mezzanine tranche is aligned to Italy’s credit risk and in this way it could be underwritten, together with the senior tranche, by the ECB until depletion of the available plafond. The residual part of the mezzanine tranche (or the whole amount, in the absence of the ECB intervention) should be bought by institutional investors through the “substitution scheme” described in § 3.

3.2. Structuring of a government/EIB guaranteed ABS with an underlying portfolio composed by low quality assets

The structuring of a government/EIB guaranteed ABS with an underlying portfolio composed by banking loans rated “double C” includes a guarantee on the mezzanine tranche provided by both the government and the EIB. In this way the two guarantors share the same amount of the overall risk appetite of 30%; consequently, the originating banks are expected to buy the re-dimensioned junior tranche equal to 12%. The EIB sup-

port would enhance the rating of the senior and mezzanine tranches as well as increase the weight of the senior tranche (see above § 3.1).

Given the above hypothesis, the resulting structure (base 100) is the following:

Junior 12
Mezzanine (A) 33
Senior (AA) 55

The risk of the mezzanine tranche is aligned to Italy's credit risk and mitigated by the EIB guarantee, contributing to its upgrade. This tranche could be underwritten, together with the senior tranche, by the ECB until depletion of the available plafond. The residual part of the mezzanine tranche (or all of it, in the absence of the ECB intervention) will be bought by institutional investors through the "substitution scheme" described in § 3.

3.3 Structuring of a government guaranteed ABS with an underlying portfolio composed by average quality assets

The structuring of a government guaranteed ABS with an underlying portfolio composed by banking loans rated "double B" includes a government guarantee on the mezzanine tranche. The government is characterized by a risk appetite of 9%; consequently, the originating banks are expected to buy the re-dimensioned junior tranche equal to 6%.

Given the above hypothesis, the resulting structure (base 100) is the following:

Junior 6
Mezzanine (BBB) 15
Senior (A) 79

The risk of the mezzanine tranche is aligned to Italy's credit risk; in this way it could be underwritten, together with the senior tranche, by the ECB until depletion of the available plafond. The residual part of the mezzanine tranche (or all of it, in the absence of the ECB support) should be absorbed by institutional investors through the "substitution scheme" described in § 3.

3.4. Structuring of a government/EIB guaranteed ABS with an underlying portfolio composed by average quality assets

The structuring of a government/EIB guaranteed ABS with an underlying portfolio composed by banking assets rated "double B" includes a guarantee on the mezzanine tranche provided by both the government and the EIB. In this way the two guarantors share the same amount of the overall risk appetite of 9%; consequently, the originating banks are expected to buy the re-dimensioned junior tranche equal to 6%. The EIB intervention would enhance the rating of the senior and mezzanine tranches and increase the weight of the senior tranche (see above § 3.3).

Given the above hypothesis, the resulting structure (base 100) is the following:

Junior 6
Mezzanine (A) 12
Senior (AA) 82

The risk of the mezzanine tranche is aligned to Italy's credit risk and mitigated by the EIB contribution, thus allowing its upgrade. This tranche could be underwritten, together with the senior tranche, by the ECB until depletion of the available plafond. The residual part of the mezzanine tranche (or all of it, in the absence of the ECB intervention) should be bought by institutional investors through the "substitution scheme" described in § 3.

4. Conclusions

This paper is a preliminary attempt to offer some schemes of ABS's structuring, in light of the recent ECB measures.

While preserving a good level of credit quality for the securitized assets, different models are proposed in order to cover a broad range of potential risks related to the underlying portfolios of Eurozone banking loans. The calculations are focused on the Italian case, but the methodology can be easily generalized to other Eurozone countries.

A summary of our schemes is contained in the table below:

Credits Portfolio Rating	Double C			Double B		
	Tranche	Rating	%	Tranche	Rating	%
Government Guarantee	Junior		12	junior		6
	Mezzanine Guaranteed	BBB	36	Mezzanine Guaranteed	BBB	15
	Senior	A	52	Senior	A	79
	Risk Appetite		30	Risk Appetite		9
Guarantee 50% Government + 50% EIB	Junior		12	junior		6
	Mezzanine Guaranteed	A	33	Mezzanine Guaranteed	A	12
	Senior	AA	55	Senior	AA	82
	Risk Appetite		30	Risk Appetite		9

The final choice among the different outcomes will depend on the risk appetite of guarantors, on market evaluation and on the criteria and the size of the ABS purchase program that will eventually be defined by the ECB.

According to our preliminary simulations, the issuing of ABS in Italy could reach up to € 50 billion (where half or event two third of this amount may be earmarked to new loans) within an ABS purchase program launched by the ECB of a maximum amount of € 500 billion over the next two years.

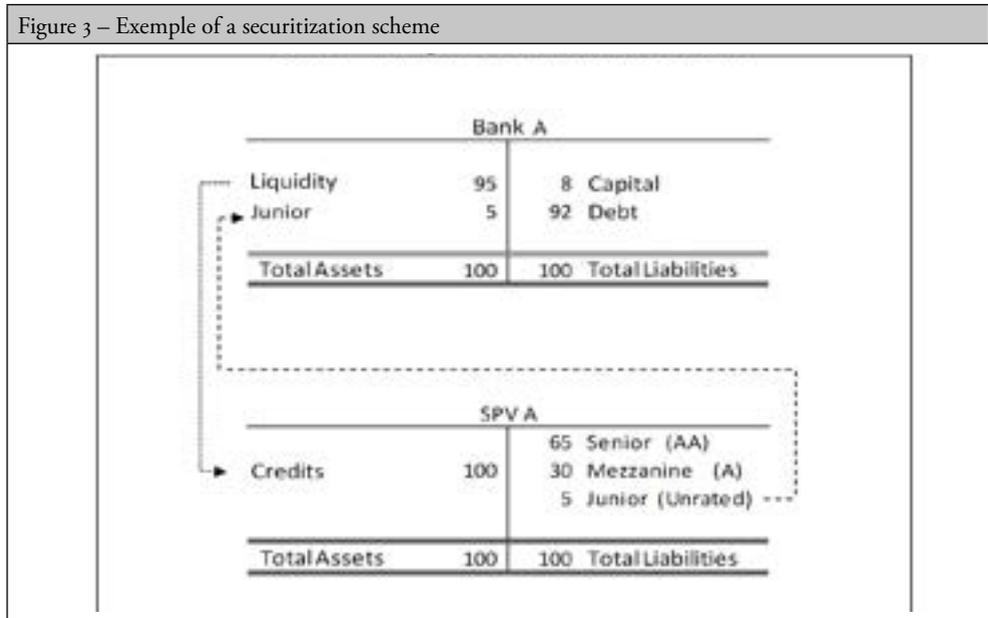
ANNEX – ASSET BACKED SECURITIES – AN OUTLINE

ABS are financial assets issued by legal entities set up ad hoc (Special Purpose Vehicle – SPV) in the context of securitization transactions. (Figure). In particular, a bank – in the perspective of freeing financial resources to be invested or to improve its balance sheet – transfers specific “asset classes” (for example loans, mortgages, of other credits) to the SPV

The SPV receive the liquidity needed to acquire the assets from the bank by issuing ABS. Consequently, the SPV is structured in order to be risk-neutral. In particular:

- ABS reflect the overall risk of the underlying assets, that are re-arranged in a standardized way producing different categories of bundled assets (tranches), with different and decreasing level of risk (respectively junior, mezzanine and senior);
- ABS cash flows are aligned with those of the underlying assets (by using so-called asset swaps).

The tranches with lower risk are placed on the market, while the ones with higher risk (junior) – which are engineered to absorb the portfolio losses – are usually bought directly by the bank.



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Development banks: from the financial and economic crisis to sustainable and inclusive growth

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1. Introduction

Global financial markets are undergoing a great transformation. In that process, they are not fulfilling, as they should, their necessary role in financing the real economy (primarily in terms of long-term, patient, capital investment). Development banks are in a position to partially fill in that gap; by further using their risk absorption capacity and by acting as a broker of developmental/transformational financing. There is a great opportunity for development banks to re-invent themselves. They have the credibility to act as intermediaries of financial flows for a number of reasons: long history (track record); predictable (non-volatile behavior); not tainted by financial crisis abuses; known as carefully structuring transactions; in-depth local knowledge; benefit from preferred creditor status; have political weight, have delivered returns consistent with risk (and market).

Moreover, development banks fill market failures and may have a role in balancing economic cycles. They may also have a subsidiary role to support commercial banking, which may receive cost-covering margin for on-lending promotional loans on non-discriminatory basis. In doing they become, in specific circumstances, complementary to the market, on the principle that privileges of development/promotional bank (tax exemption, public guarantee) do not distort competition. The costs of promoting are low (as the promotional bank does not need local branches and they often enjoy State-guarantees on the funding and/or the lending) and only economically sound projects (examined by the on-lending banks) are promoted.

In 2005, the UN defined these type of institutions as “Government owned financial institutions with the objective of fostering economic or social development by financing activities with high social returns” (UN 2005) The UN added that they target well identified market failure; lending does not crowd – out the private sector; their business model has to be financially sustainable; and, finally they need an adequate governance to ensure that these requirements are met (risk of public failure).

Among the new instruments which may need to be reinforced by Governments’ agencies, Multilateral Development Banks (MDBs) and National Development Banks (NDBs), there are credit enhancement mechanism, such as monoline mitigation mecha-

nisms, which may include credit and risk guarantees, first-loss provisions, and the provision of bridge financing via direct loans.

New instruments and new agencies (MDBs and NDBs) are therefore going to be needed to mitigate risk and face credit crunch. They should work as catalyzer of institutional investors participation to infrastructure financing by playing credit enhancement and leave to institutional investors the senior part of debt and by attracting co-investments in the equity side of the projects.

In Europe, for example, on the debt side, the Project Bond Initiative (PBI) goes in this direction; while on the equity side, long-term infrastructure funds such as the Marguerite Greenfield LT Fund could be used as “prototypes” for broad “families” of long-term funds for investment in infrastructure, technology, R&D, SMEs, start-ups, local utilities, energy, urban development, health care compensating for the general shortage of risk capital engendered by the crisis.

While waiting for a return of stability in the European banking system, the role of large national and multilateral development banks (EIB, KfW, CDC, CDP,.) has become increasingly important. New financial instruments have been designed; additional resources have been mobilized to support the economy during the crisis, most importantly by financing infrastructure and SMEs, either directly or through the banking system; and new European and domestic long-term equity funds have been launched to invest in infrastructure projects and strengthen company capitalization. Cooperation between these institutions could lead to further new initiatives and new instruments.

At the global level, the MDBs and the NDBs have played a major role in alleviating the effects of the financial and economic crisis started in 2008. A similar role, they played during the 1986-90 debt crisis (affecting mostly Latin America) and the 1996-97 ‘Asian crisis’. As a matter of fact, the 1986-90 crisis had a major function in helping both MDBs and NDBs in ‘re-invent’ themselves by broadening they activities from project lending anchored to specific projects to structural adjustment lending geared to support structural economic reforms.

A further stimulus to change came from the G20 itself. In 2013, at the G20, under Russian Presidency, in Saint Petersburg in the month of July, for the very first time, a large group of G20 official financial institutions named D20 (which included national development and promotional banks, other G20 national or nationally-mandated long-term public financial institutions and European Investment Bank, EIB) gathered during the international Conference on “Sustainable Growth through Long-Term Investment”. At the end of the Conference they issue a Common Statement to be delivered to the G20 Heads of States. One of the point which characterized the Statement is the common view that “they believe that active support from G20 official financial institutions is crucially important for those programs and projects, which require long-term financing, in sectors such as national and trans-border infrastructure, green, innovative and inclusive growth projects, and projects on mitigation of climate change and its aftereffects, as well as systemic support to SMEs and entrepreneurship.”

The second meeting of the D 20, under the auspices of the G 20 under Australian Presidency, will take place in Rome in the month of July 2014 during the international

Conference "Improving the Financing of Sustainable Growth: The Role of D20 Institutions". The aim of the Conference is continue to discuss their role in helping address the global challenge of achieving green and sustainable growth. They will particularly focus on the importance of attracting private long-term finance to infrastructure and SMEs to use the scarce public resources in the most effective way and to enhance the D20 catalytic role. They also will emphasize the synergies that could result from closer cooperation between the D20 and the MDBs in a common efforts to support growth and employment.

The D20 is a group of diverse financial institutions, which however share a common mission to support the converging public policy objectives of the members of the G20, their respective shareholders.

So there is great momentum and growing role of development and promotional banks around the world. In this paper we will discuss some of the practical and theoretical issues which came from this new wave in the global financial markets.

The conclusion of the 'umbrella paper' prepared by the World Bank staff for the 2013 meeting are still valid (World Bank, 2013). Specifically, in the initial phase, it is diagnostic work on long-term investment is to be undertaken on the following broad issues: recent evolution/developments in long-term financing, including the impact of the global financial crisis on the availability of long-term investment financing, impact of crisis related systemic developments on country specific factors, supply of and demand for long-term investment financing.

In the last sixteen months, several countries have started this work, with the technical support of MDBs and of their own NDBs.

2. The concept and functions of development finance corporations/development banks

Let us take the Britannica Encyclopedia definition whereby 'development banks are national or regional financial institutions designed to provide medium and long-term capital for productive investment, often accompanied by technical assistance, in poor countries'. Now, the term 'poor countries' ought to be revised as in their actual work many development banks have the specific objective to help countries in transition from planned to market economies and in a structural adjustment process. The area of the euro is undergoing a major structural adjustment process, albeit with different timing and intensity in the numerous member countries. The main determinant is that sometime in the final decades of the twentieth century, the European Union (EU) and North America lost the monopoly of technical progress they had enjoyed since the end of the eighteenth century; thus, although with different and differing degrees, its member countries need to adjust to a new and rapidly changing world wide environment (Gros, Alcidi 2013). Furthermore, for several years a primary purpose of development banks has been to provide access to international capital markets to Government and countries that either were considered too risky by international lenders or featured highly protected economies through trade restrictions and exchange controls with, as a result, exchange rates that did not reflect the economic value of the scarcity of their foreign exchange. Now, because of trade and exchange control liberalization as well as because

of international economic and financial integration, neither the World Bank Group nor the major international regional development banks have this function any longer, at least as their primary aim and objective. A recent paper (Kapur, Raychaudhury, 2014) describes quite effectively how the World Bank Group has been drastically revising its aims and objectives to 'fight world poverty' – a highly challenging task but also quite different from that of promoting manufacturing and infrastructure for which development finance corporations were originally conceived.

The key point is that development banks are different from commercial, poly functional, universal and investment banks (*viz.* other categories of banking) in that they have the aim of providing medium and long-term capital for productive investment, often accompanied by technical assistance. Also, the productive investments should be identified, appraised and selected with a two-fold set of criteria: in the short term, they should help make full utilization of production factors (and thus increase employment) and in the medium and long-term, they will provide physical, financial and technical capital (and thus, increase productivity of the production factors). In short, they should be both Keynesian and neo-classical. This, we may consider as one the key discriminating feature between development banks and other categories of investment banks.

The number of MDBs and NDBs has increased rapidly since the 1950s; they have been encouraged by the success the International Bank for Reconstruction and Development and its affiliates (normally known as the World Bank Group), created in 1944 at the Bretton Woods conference with the primary objective of helping reconstruct countries that had been devastated by World War II. The large regional development banks include the European Investment Bank established as a part of the Rome Treaty in 1957, the Inter-American Development Bank established in 1959; the Asian Development Bank which began operations in 1966; and the African Development Bank, established in 1964, the European Bank for Reconstruction and Development which opened for business in 1991. There are smaller development banks on a sub-regional basis. There is also a large number of NDBs that, in their operational policies and practices, often follow, by and large, the more established large MDBs.

Although the Russian Vnesheconombank established in 1917 can be considered a forerunner of national development finance corporations, many now important national development banks have been created in the last few decades and grown there since: eg. the Brazilian Banco Nacional de Desenvolvimento Econômico e Social, the Mexican Banco Nacional de Comercio Exterior, the Korean and the China Development Banks, the Indonesia Exibank, the Export-Import Bank of India, the Development Bank of Southern Africa, the Industrial Development Bank of Turkey. This list is by no means exhaustive but only indicative. A review of their prospects shows that, although there are differences in approaches and procedures, their emphasis is on lending and equity infrastructure financing, supporting Small and Medium Size Enterprises (SMEs) and providing relief to poverty, and eventually eradicating it, through productive activities. Several of them are State Owned Enterprises (SOEs), but the share of private investors in their capital structure is increasing.

Normally, the MDBs and the NDBs make loans for specific national or regional projects to private or public bodies or may operate in conjunction with other financial institutions, primarily for on-lending functions. One of the main activities of the development banks has been the recognition and promotion of private investment opportunities, especially in industrial manufacturing. However, the main efforts of the majority of development banks are directed toward infrastructure and the industrial sector as well as agriculture and human resources at large (education, health). Development banks have had a special role in formulating, experimenting with and implementing both private and public investment projects with the outlook of maximizing social returns to the community not only private returns to the investors. Now, as mentioned in the previous paragraph, the challenge of fighting world poverty is becoming the primary purpose of the major international development banks. This entails major revisions in investment appraisal parameters and programs and projects selection criteria (Pennisi, Scandizzo, 2004, 2006. Cnel 2012).

MDBs and NDBs may be publicly or privately owned and operated, although governments frequently make substantial contributions to the capital of private development banks. The form (share equity or loans) and cost of financing offered by development banks depend on their cost of obtaining capital and their need to show a profit and pay dividends. A frequent critique is that their standard appraisal methodology does underestimate the environmental costs and ramifications of many categories of investments (Graves, 2012).

NDBs practices have provoked some controversy. Because development banks tend to be government-run and are not accountable to the taxpayers who fund them, there are few checks and balances preventing the banks from making bad investments or investments that do not account adequately for their external effects (eg on sustainability).. Some NDBs have been blamed for imposing policies that ultimately destabilize the economies of recipient countries. Yet another concern centers on ‘moral hazard’—that is, the possibility that fiscally irresponsible policies by recipient countries will be effectively rewarded and thereby encouraged by bailout loans. While theoretically a serious concern, the existence of such moral hazard has not been yet proven.

An example of a successful wholly private development bank is the Grameen Bank founded in 1976 to serve small borrowers in Bangladesh. The bank’s approach is based on microcredit —small loans amounting to as little as a few dollars. Loan repayment rates are very high, because borrowers are required to join ‘lending circles’. The fellow members of a circle, which typically contains fewer than ten people, are other borrowers whose credit rating is at risk if one of their members defaults. Therefore, each member drives other members to pay on time. The Grameen approach has spurred the creation of similar banks in numerous developing countries (Yunus, 2003) and also in advanced countries with generally good outcome (Calvi,2003; Pellegrina, Scollo, 2014).

3. Domestic Development Banks in Europe

This general overview is useful to focus on the domestic national development banks in Europe and on the role they have in the exit from the European crisis. First research

does indicate that LTIs may have a positive effect on income distribution, at least at narrowing the gaps emerged in the recent past (Bassanini, Reviglio, 2009; Bassanini, Reviglio 2011; Bassanini, Reviglio 2014; Mattauch, Edenhofer, Klenert, Benard, 2014). A recent World Bank Policy Research Working Paper (Yifu Lin, Doemeland, 2012) does emphasize that Long-Term Investments (LTIs) are the necessary tool for an exit strategy from the crisis that has plagued the world economy since 2007. LTIs require long-term financing by development bank. In Europe, the most significant are the Italian Cassa Depositi e Prestiti, the French Caisse des Dépôts et Consignation, the German Kreditanstalt für Wiederaufbau. There are many smaller development banks such as those of Austria, Bulgaria, Croatia, Greece, Poland, Spain, Turkey, the United Kingdom, and other countries.

In 2010 a study by Dalberg Global Development Advisors, an international consulting firm, examined the methods and effectiveness of the national development banks in Europe on a commission by the European Development Finance Institutions EDFI (Dalberg Global Development Advisors, 2010). The EDFI association has fifteen members – all of them are development banks. The concrete goal of the study was to describe the growing role and tasks of the national development banks in Europe and to highlight opportunities and challenges. Because many national development banks are under mandate to finance the private sector, this was given special attention. One of the highest hurdles for local businesses in these countries is the lack of access to financial services. The Dalberg study clearly shows that the private sector is the engine for growth not only in advanced market economies but in developing and transition economies as well, and that, in doing so, it makes a significant contribution to the reduction in poverty. In general, EDFI members act in accordance with three principles: a) They are present where other investors are not (yet) there; b) They act as catalysts and their presence prompts the involvement of others; c) They operate in a sustainable manner because they reduce dependence on aid payments by relying on employment and growth as sustainable sources for financing developing countries and emerging markets through taxes. In short, as mentioned in the previous section, the emphasis is not in providing access to international capital markets (the earliest purpose of several development banks) but to help channel savings towards investment with short term Keynesian effect to increase and improve utilization of production factors and, in the medium and long-term, to increase and improve productivity and, thus, competitiveness.

According to the study, the fifteen specialized European institutions have succeeded in both prompting positive developmental momentum in developing and transitioning countries as well as in enjoying financial success in numerous projects. The requirement that the investments be financially successful has also kept the infusion of capital from national governments at a moderate level; up to now they have represented only a small part of the financial strength of NDBs. European countries were also able to credit the work of their national development banks to their progress in achieving the UN-Millennium Development Goals and in part to their respective Official Development Aid quotas. The study summarized by saying that the NDBs have now long established themselves as a third pillar of international development policies along with classical

development work and the MDBs. In the last ten years they have emphasized environmental-friendly development.

Italy has a special tradition and role in development banking. A recent study by Amadeo Lepore (Lepore, 2012) reviews the history of the Cassa per il Mezzogiorno, the forerunner of many European national development banks, and confirms previous research by Alfredo Del Monte and Adriano Giannola (Del Monte, Giannola, 1978) that until the mid nineteen seventies the Cassa operated as one of the finest European development banks, was often praised by the World Bank Group itself and shown as a model to imitate; as indicated above, from the end of World War II to 1964, when Italy 'graduated' from being eligible for World Bank lending, all the World Bank operations for Italian reconstruction and development were made through lending to the Cassa not to the Government or some of its Ministries. A number of financial development agencies operated along with the Cassa; some of them were specific small industrial development banks to finance manufacturing in Sardinia and Sicily; others to provide support services in area such as training and project planning. Although since the mid nineteen seventies, the quality of their operations deteriorated greatly and this led to their demise, the Cassa experience is a useful building bloc to identify strength and weaknesses of national development banks for setting Europe back on a growth path.

More recent and more telling is the transformation, in the last ten years, of the Cassa Depositi e Prestiti (CDP) from a department within the Ministry of Economy and Finance to a development bank, with private minority shareholders (banks), offering a full array of services either directly or through specialized funds (De Cecco, Toniolo, 2013). CDP maintains its original objective of financing long-term investment in infrastructure but also lends and provides equity to strategic and innovative initiatives. In short, it has acquired a range and depth of activities even larger than those of the longer established Caisse des Dépôts et Consignation and Kreditanstalt für Wiederaufbau. With these and others (including non-European) institutions CDP has helped establish a Long-Term Investors Club (LTIC) with the specific objectives to channel savings towards well conceived and thoroughly appraised long-term investments to promote economic and social development, while providing a decent long-term return to the investors (Bassanini, 2012).

This general overview provides a preliminary answer to the question raised in the first section. Development finance corporation and development banks – the difference is only nominal – may help Europe to increase its growth rate and to provide a more even distribution of growth benefits if they provide lending and equity support to well conceived and well appraised investment in infrastructure and strategic and innovative initiatives. This may very well require harmonization of appraisal parameters and selection criteria, especially when dealing with innovative programs and with projects where attempt is made to factor in equity standards in operations primarily designed to improve factor utilization and productivity.

4. Green, inclusive and sustainable growth: the role of development banks

No doubt, MDBs and NDBs have contributed to economic growth after World War II. This has transformed and improved the quality of day-to-day life to nearly two billion of people. Even though, the EU has been in a stagnation and recession for the last two decades and now its prospects point to sluggish growth, Singapore, Taiwan, Korea and more recently, albeit to a lesser extent, Brazil, China and India offer vivid and live examples of societies that went from massive abject poverty to level of income and social development comparable to the most advanced economies. They increased living standards by moving resources into new and higher productive activities, and continually building the productivity base with investments in infrastructure, human resources and institutions (Sapelli, 2014). This path has accelerated since the last decade of the twentieth century because, as indicated in the previous section, a comparatively small group of advanced countries lost the monopoly of technical progress it had enjoyed and benefitted since around 1830 (Maddison, 2007). The world economy is now undergoing a major restructuring in terms of production, consumption, savings and investment: no one can foreseen how long such a restructuring will require and what the final outcome will be.

Even though highly unequal sharing of growth in many economies and societies (Piketty, 2014) has made of us quite skeptical about economic growth as the only avenue to betterment of human well-beings, there is no precedent for ameliorating economic and social welfare on a large scale without rapid and sustained expansion. The destiny of both advanced and developing countries – and hence of the EU itself – rely upon their ability to nurture and sustain growth.

This also implies that we must periodically rediscover that growth is a multidimensional process. More specifically, and getting at the core of this meeting, ‘green’ and inclusive growth does not simply happen by itself or a consequence of good rates of GDP expansion. It is the result of getting the right mix of investment and policies at the right time. Mistakes along the way are inevitable; they should be seen as a part of a learning and adaptation process (Hirschmann, 1968) necessary for carrying out and sustaining a successful strategy. In a recent review of his own thirty years experience in the field, a well versed development economists (Zagha, 2014) rightly maintains that ‘successful Governments have operated in a time frame that by far exceed the project cycles and the shelf life of a development bank typical economic report; these successful Governments have not been afraid to stay engaged, even when they to retreat from a specific ineffective policy or program’.

As a matter of fact, there no ‘silver bullet’. A quarter of a century ago, the general belief was called ‘the Washington consensus’ (Williamson, 2004) and the international financial institutions, including MDBs (as well as several NDBs), adopted as their standard therapy on the assumption that making the market work, liberalizing, deregulating and privatizing would provide the path to development. This proved to be overly simplistic and often counterproductive. While the search for best practices can hardly be challenged, one size does not fit all. For development banks, especially for those with high profile either domestic or international, the real challenge is to remain eclectic and craft custom-made solutions that nonetheless draw on a vast experience because the re-

ality of development, especially of 'green' and inclusive development, is much complex and quite messy affair.

In any case, development needs development finance which is a special blend of finance – not just equity or lending (even concessionary lending). Development finance does not mean merely long-term finance, but long-term finance coupled with the capacity to provide technical assistance to the borrower and to evaluate financial and social returns as well as to assess the opportunities and the risks inherent in development projects and programs and to formulate supporting policy measures. Only institutions with this capacity can, for example, evaluate a program of investments and associated changes in the tariff regime, fiscal transfers, and regulations. Or appraise a major infrastructure program and address its environmental dimensions. Specialized knowledge must be integrated with finance. For this very reason, the LTIC is a most needed, not only, a most appropriate tool to foster development in the EU.

It is useful to recall that it has been a long-term mistake to think that development strategies are a real concern solely or primarily the developing countries. Development is addressing long-term structural impediment many of which are present in advanced countries, namely in many EU countries, such as the quality of education, social mobility, modernization of infrastructure, restructuring of public spending and fiscal/budgetary reform. The basic issues are the same. Indeed, the forerunners of long-term development institution, the World Bank Group (Kapur, Lewis, Webb, 1997) started its activities in what today are some of the most advanced countries of the world: Japan, France, Italy. The dichotomy between structural issues in advanced and developing countries is in many respects, artificial; in fact the commonality of interests is increasingly significant. For these reasons, specific European lending institutions, such as the European Investment Bank (EIB) and the European Bank for Reconstruction and Development (EBRD) have borrowed many practices from the World Bank Group but can benefit from the experience of only a limited group of countries and have in certain instances found it difficult to formulate pragmatic policy perspectives to guide their operations. The LTIC has a vantage points over them because it blends different cultures and a wide range field of experience.

Europe 2020 – eg. the EU ten-year growth and jobs strategy launched in 2010 – takes into account some of the consideration summarized above. It is about more than just overcoming the crisis from which our economies are now gradually recovering. It is also about addressing the shortcomings of our growth model and creating the conditions for a smart, sustainable and inclusive growth (Gros, Roth 2013). Five main targets have been set for the EU to achieve by the end of 2020. Within the overall objective of a 'smarter, greener and more inclusive Europe' in 2020, these targets cover employment; research and development; climate/energy; education; social inclusion and poverty reduction and include specific indicators (European Commission, 2013). The objectives of the strategy are also supported by seven 'flagship initiatives' providing a framework through which the EU and national authorities mutually reinforce their efforts in areas supporting the Europe 2020 priorities such as innovation, the digital economy, employment, youth, industrial policy, poverty, and resource efficiency.

Other EU levers such as the European single market, the EU budget and the EU external agenda also contribute to the achievement of the goals of the Europe 2020 strategy. The Europe 2020 strategy is implemented and monitored in the context of the European Semester, the yearly cycle of coordination of economic and budgetary policies. The EU Commission published a Communication taking stock of the Europe 2020 strategy in March 2014, four years after its launch (European Commission, 2014).

5. Macro-economic policies and green, inclusive and sustainable growth

Formulation, preparation, enactment and implementation of macro-economic policies are responsibility of Governments and Parliaments. It is also Governments and Parliaments' task to see to it that they take adequate account of green, inclusive and sustainable growth elements and that they are properly implemented. Nonetheless, development banks must play a useful role. On the one hand, to be successful many large scale investment require an adequate and consistent policy context and in certain instances may entail policy changes; eg, as mentioned in the previous section, major infrastructural investment in transport, soil protection power can often be the lever for reforms in tariffs, in budgetary allocations and in other macro-economic aspects of policy. On the other hand, macro-policies may need major modifications for investment to be useful. A frequent example are the programs to help develop SMEs. Very often they need on-lending rates that mirror the economic not only the financial cost of capital; this, in turn, raises macro policy issues in banking and finance. In other instance, they may require measures to help concentrating enterprises with a view of increasing their average size, some of these measure may get to the core of completion policies – a matter not only of national but of EU concern.

Thus, even though development banks operate primarily through lending and equity participation for specific operation, their workings do intertwine quite tightly with macro-economic as well as institutional policies.

In the last thirty years, there has been a flourishing literature on how macro-economic medium to long-term development policies may take account of environmental aspects, social inclusion and the diffusion of ITC; a good, even if not fully updated review of this literature is in Fleurbaey (2009). In Italy, considerable work has been done by the Central Statistical Office and by the Economic and Social Council; a first report was published some eighteen months ago (Istat-Cnel, 2013) and its findings were incorporated in the latest Government economic policy blueprint (Ministero dell'Economia e delle Finanze, 2014). This effort is to be considered more advanced in methodology than the, internationally better known report by the international Commission established in 2008 by the French Government, generally known as the Stiglitz- Fitoussi Commission (Commission on the Measurement of Economic Performance and Social Progress, 2009). As a matter of fact, the Italian Istat-Cnel document does incorporate methodological advances and the results of empirical experience obtained in the last four years. Both the French and the Italian documents propose batteries of indicators to complement those based on national economic accounting (in short GPD growth). Development banks have often anticipated some of this evolution (Nath, Nayak, Goel

2014). Also sovereign investment funds have played a useful role (Gilligan, O'Brien, Bowman, 2014).

It is useful to underline that many of the proposals on 'green' and 'inclusive' development deal also with 'smart' (viz ICT) development, as foreseen, inter alia, in a document published by the Council of Europe some ten years ago (De Filippi, Pennisi, 2003). At that time, similar issues were dealt with, in Italy, by several other institutions such as, for instance, the National School of Public Administration (Choi, De Filippi and Pennisi, 2004) and the Fondazione Rodolfo De Benedetti (Cohen, Garibaldi, Scarpetta, 2004).

The recent documents – such as those produced by the Government of France and Italy – confirm the basic tenement reached ten years ago: environmental, social inclusion and technical (ICT) considerations must not be seen as a separate set of policies, programs and measures to be added on, or to complement, macro-economic development policies but must be merged with, and folded within, the overall macro strategy. This is not always the case, as can be seen just by perusing the National Reform Programs (NRPs) prepared by the EU countries each Spring with the view of being reviewed by the European Commission and the other EU members in order to learn lessons and harmonize growth and development strategies. In this area, development banks experience can be very useful to Governments and Parliaments because in their actual workings of lending and equity operations where environmental, social inclusion and technical (ICT) considerations are tightly intertwined with those of financial profitability.

6. Certain specific issues

In charting future activities of European development banks, we ought to start from the assumption that EU's does not – and should not – aim to the pre-crisis path because this path was unsustainable economically, socially and environmentally. A new vision is required as emphasized in Europe 2020 more specifically by the Stiglitz – Fitoussi report and by the Italian Istat-Cnel work summarized at para.4 of this paper (Codogno, 2011; Padoan, 2012; World Bank, 2012). As a matter of fact, the return of Europe to normality is highly unlikely; there a need to foster new sources of growth and competitiveness, based on knowledge intensive activities, high productivity and environmental sustainability. There need for a new vision rooted in the medium to long run (Winters, 2014) rather than on short-term financial and economic returns.

The EU, OECD and the World Bank concur that to renew expansion and make growth sustainable, medium and long-term economic policies should address the efficient functioning of the labor markets, dealing with issues such as the skill mismatch as well as areas related to the strengthening of the single market, to the integration of the financial market and policy to the transition to a 'green economy'. At first sight, only in some of these fields, the European MDBs and NDBs might have a role because they mostly pertain more to the policy realm (a Governmental function) than to an operational function (typical of development banks). However, as seen in para. 2 above, policy and operational functions are tightly intertwined; development banks have often influenced macro-economic and development policies by providing them a good balance of micro-economic considerations.

Let us take some of these specific issues individually, one by one.

The labor skill mismatch requires mostly legislative reforms, but the European development banks can enter more directly into financing skill education and training, especially at the tertiary level (university and post-university level) as pioneered by the World Bank Group in the nineteen sixties and now standard fare of the lending practices of all important MDBs (Heyneman, 2003); this may involve several activities – from supporting specific chairs to financing innovative higher education and research institutions, to providing study loans to deserving and needy students with talent in development fields and even providing equity financing to well designed institutions planned to make a steady return. Also, in certain specific cases, European development banks could enter the generally considered messy area of improving labor exchange and other labor market services (including those provided by the private sector). Specifically, the European MDBs and NDBs forming the LTIC have the chance of learning from each other national experience of failures and success stories and link financing to much needed and much required technical advice and assistance (Boeri, van Ours, 2009)

The strengthening of the single market implies an increase in SMEs size as well as improved Social Corporate Responsibility (SCR) which is often wanting in small firms especially within the context of a very competitive aggressive market. This point is frequently made in the EC annual reports on SMEs performance (European Commission, 2013); useful comments are made in scholarly essays based on the Italian experience, where manufacturing and services sectors are to a large extent based on SMEs (Perrini, 2006). Several European development banks – including CDP – have special windows to foster SMEs expansion and their participation in the global market. A useful area for analysis and action is to help SMEs to form consortia in order to issue ‘minibond’ as a finance tool for their growth; after some unsuccessful experience in the USA some ten years ago, now research, especially on South East Asia, shows very positive results (Wei, 2013). The strengthening of the financial market is mostly being pursued through the establishment of banking union, still under construction (Barrucci, Messori, 2014).

The transition to a greener economy is central to the Europe 2020 Strategy, as outlined in para. 4 above. It is all the more important because emerging economies and developing countries account for 60% of the global CO₂ emissions and their economic growth is driving the emissions to increase. The reduction targets of the Kyoto Protocol were not achieved because Canada, Japan, Russia and the USA dismissed their participation. ‘Common global’ agreements in the energy policy- such as carbon price and energy technology standards- are needed to cut emissions. The unilateral EU approach to reduce its emission by 40% by 2039 will have a marginal effect on the global emission trend, with the risk of negative repercussions on European competitiveness (Clini, 2014). In this area, the European MDBs and NDBs have a vantage point because some of them do participate in major power companies and also due to their operational work in areas such as ‘smart cities’ and recovery of industrially distressed areas(Carraro, Fay and Galeotti. 2014).

7. Micro-economic methodologies to include and green, inclusive and sustainable growth in investment appraisal

Financial and economic analysis at the micro level is the staple work of both MDBs and NDBs, especially if they deal with long-term investment. Since the mid-nineteen eighties an important professional quarterly, *Impact Assessment and Project Appraisal*, published by Elsevier, has been providing a wealth of analytical essays and actual case studies on sustainable development. In the last years, members and subscribers of the Social Science Research Network SSRN receive daily an *Environmental Economics E-Journal* with abstracts of the main papers on the subject and the possibility to download them. Similarly, there is a very extensive literature on technological progress and inclusive growth. In Italy, specific empirical experience (including actual ‘case studies’ was published by the Associazione Italiana di Valutazione (eg Pennisi, De Filippi, Mazzanti, De Castris, Pellegrini, Centra, Scandizzo, Maiolo, 2005; Bezzi, Cioffi, De Ambrogio, Ghetti, Martelli, Oliva, Palombini, Pennisi, Rosciglione, Samek Lodovici, Silvani, Sisti, Vecchi, 2006;) as well as in monographs by the Unità di Valutazione of the Economic Development Ministry in a special series called *Materiali UVAL*.

In a recent paper (Pennisi, 2013), one of the authors of this paper reviewed the current status of the art in this field. LTIs have distinct and special features as compared with short and medium terms investments (Clements, 2011). These features occur especially in the infrastructure sector: the planning and construction of a major transport network, involving both highways and railways (and even including airways and waterways), is vastly different from a road maintenance program. (Briceno Garmedia, Sarkodie 2012). This is even more apparent when LTIs deal with research and innovation, human capital, energy, environment, and the like (Fukuya L., Alva L. 2010; Edler, Berger, Dinges, Gok. 2011).

Their main characteristics are as follows.

- A long physical implementation and gestation period before financial returns and economic and social benefits provide a positive long lasting net cash flow.
- A long temporal distance between the decision of financing a project and its “physical implementation”: within such a temporal lag, the major strategic variables can change their trend especially in presence of fast social and technological changes as it is now and will hopefully stronger in the future. This requires a high capability of reading simultaneously a large number of variables.
- Serious intergenerational issues because financial and economic costs fall principally on the generation designing the investment and deciding to go ahead with it, as well as using the required resources, while financial and economic benefits typically accrue to the next generation(s); the calculation of their discounted present values present theoretical issues as well as policy, technical and operational ones.
- Uncertainties as opposed to risks in estimating financial and economic costs and benefits and their flows because of the long time-span involved. Attempts to use “averages” or to “shadow price” for future long-term costs and benefits have often proven unsatisfactory, especially from the operational and practical standpoints.

- “Lumpiness” of the LTIs; whereas for physical implementation and contracting purposes, any LTI can be, and often need to be, divided in temporal stages or phases and in specific “technical packages” for bidding and contracting purposes, their conceptual integrity is such that the various stages/phases and/or “packages” cannot have financial and economic costs and benefits distinct from those of the overall LTI. This has implications for both the use of resources and the feasibility of interrupting the investment or of changing its content and components, during its implementation., or modifying its objectives, contents and phasing (Sunstein, 2011)
- There are significant differences in outlook between private and public partners. Normally, the former are interested in not overly deferred financial returns for their stakeholders and shareholders. The latter are generally interested in promoting improved welfare and living standards of future generation(s) not solely of the present decision makers and their constituents (Magni, 2011). These issues are well known to the literature (Ferrara, 2010; Glachant, Lorenzi, Quinet, Trainar, 2010, Pennisi, Scandizzo, 2004) and have often been resolved with elegant economic and mathematical modeling but also with quite practical simplified approaches and operational manuals – developed by the EU Commission as well as by the Ministries of Finance and Economics or of Economic Development in almost all major advanced and developing countries. Advanced methodologies (eg. including ‘real options techniques’ to provide value for uncertainties) have been applied to investment such as airport planning in Northern Europe, substitution of analogical television with Digital video Broadcasting – Terrestrial (DvB-T) in Italy, regional planning in several European countries. In these and many other examples, full consideration has been taken for environmental aspects, ITC dimension and social inclusion. This implies that experts in finance and economics have worked very closely not only with engineers but also with environmentalists, ITC specialist and social scientists and brought to bear an interdisciplinary dimension often missing in macro policy analysis.

In Italy, a recent document of the Economic and Social Council to the Government and Parliament (Cnel, 2012) has cleared some the issues and ambiguities several OECD and EU countries are still struggling with. Most specifically, the document proposes to adopt as a numeraire the critical level of consumption – viz. the level of consumption of the individual subject who does not receive subsidies and has no taxes to pay – and to handle intergenerational issues the Modified Discount Method (MDM). These technical instrument facilitate the incorporation, in investment analysis, of environmental aspects, ITC dimensions and social inclusion considerations. With the support of Regional research institutes, the Italian Economic Development Ministry is working on the formulation of operational guidelines.

In the realm of macro economic development policies, there are not simplified synthetic indicators similar and as meaningful as those developed in social cost benefit analysis of LTIs. Thus, it is necessary to resort to a vast batteries of indicators such as those proposed by the Stiglitz- Fitoussi Commission in France in 2009 and by the Central Statistical Office and the Economic and Social Council in Italy in 2013. Nonetheless, a fuller integration of development banks work with the work of the central Economic

Ministries, the Statistical Offices, Economic and Social Councils (or alike) may bring about a simplification of the now very extensive batteries of indicators and provide useful macro policy planning tools.

8. Summary and issues for discussions

This paper reviews the role of development banks in the process of improving development, with special attention to the EU. In its first part, it proposes a definition of development and singles out the differences from other types of banking (commercial, poly functional, universal investment banking) because their aims and objectives are to foster multifaceted and multidimensional development through LTIs geared not merely to output growth and good financial returns but also to environment protection and promotion, ICT diffusion, and social inclusion.

The paper maintains that there is not any significant difference between development banks operating in advanced countries for advanced countries development and development banks operating internationally and/or domestically for developing countries development. Their basic aims and objectives and operational tools are quite similar both conceptually and procedurally; however, in Regional areas, such the EU and the euro zone, development banks may benefit from harmonizing their investment appraisal parameters and selection criteria.

Development banking has built, over the years, experience in marrying output growth with environmental, technological and social inclusion considerations. These are areas where at the macroeconomic policy level many a countries are wrestling with and proposing batteries of indicators to complement national economic accounting. In these very field, development banking applies synthetic investment value indicators that captures, in an effective and eloquent manner, both output growth and aspects such as environmental, technological and social considerations. Thus, the development bank's experience can be a useful base on which central Economic Ministries, Statistical Offices, Economic and Social Councils (or alike) may wish to build upon in refining their development work.

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