OECD-Euromoney Conference on Long-Term Investment Financing

Investment financing in the European Union

Keynote address by Ignazio Visco, Governor of the Bank of Italy

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I first wish to thank the OECD and Euromoney for inviting me here today.

Following the outbreak of the global financial crisis, Europe experienced a large fall in investment, which continued throughout the sovereign debt crisis. The fall was unusual in terms of severity and duration. Set equal to 100 its pre-crisis peak in 2007, in 2014 real gross fixed capital formation was still lower than 85 in the euro area while it had almost fully recovered in the United States and the whole OECD economies. Moreover, investment trends in Europe were very heterogeneous: compared to a level of 100 in 2007, last year real gross fixed capital formation was equal to 105 in Germany, 97 in the United Kingdom, 94 in France and lower than 70 in Italy and Spain.

There is no need to add much on the short- to medium-term outlook, except to underline that the growth recovery in advanced countries, and especially in the euro area, is still fragile, as it faces non-negligible headwinds from the slowdown in emerging economies. The dramatic recent developments, which culminated in the so difficult to comprehend, and cope with, terrorist attacks here in Paris, certainly add their negative weight on confidence and raise the level of uncertainty. This may make the recovery in capital accumulation more difficult to sustain.

It is against the backdrop of such an exceptional decline in capital formation that we have to analyse investment financing in Europe. I will offer some remarks on three issues: the need to diversify the European economy's sources of financing and overcome financial markets fragmentation; the challenges of the Capital Markets Union (CMU); and some key issues that come up in financing infrastructures.

1. Diversifying financing sources and improving financial market integration

The European Commission proposal unveiled last February to establish a Capital Markets Union by 2019 has among its primary objectives the broadening of non-bank sources of financing and lowering barriers to cross-border investment.

The need to achieve a more diversified financial system is especially due to the bank-centric character of European financial systems. The European economy is as big as the US one, but Europe's equity markets are less than half the size, its non-bank debt markets less than a third. According to the Commission's estimates, European SMEs receive five times less funding from capital markets than their US peers do.

Identifying the effect of financial factors on corporate decisions has always been a daunting task. Nonetheless, econometric estimates by the Bank of Italy show that the collapse of corporate investment in Italy since 2007 was aggravated at the height of the crisis by financial factors, namely tightening in banks' lending standards and the surge in the user cost of capital. These factors were obviously connected with the heightened uncertainty determined by the global financial crisis and the sovereign debt crisis in the euro area, which also led to a very weak credit demand.

It is fair to say that the dominance of bank lending is one of the causes underlying the slower recovery of the euro-area economy when compared with more diversified financial systems such as in the US or the UK. There is evidence that, during recessions, market-based financial systems are more resilient than bank-centric systems, especially when the fall in economic activity goes hand in hand with a financial crisis. Moreover, as economies develop, capital markets become comparatively more important because they improve investors' portfolio choices and risk management techniques and broaden the set of financing tools available to borrowers.

As the most acute phase of the financial crisis and its aftermath is over, a number of factors weigh on bank lending. On the one hand, the major overhaul of financial regulation is reflected in stricter banks' capital, liquidity and leverage ratios. Moreover, the low-return environment tightens banks' margins. On the other hand, the demand for credit is weakened by non-financial corporations' drive to deleverage and the challenging economic environment.

The regulatory push and the other forces, while combining to build a safer financial sector, are leading banks to adjust their business models, with longer-term effects on their lending activity.

The CMU aims to promote a financial system that is not only more diversified but also more integrated across countries. Financial market integration in Europe is incomplete and fragile. In 2011-12, at the peak of the crisis, fragmentation of the euro area financial markets along national lines made an abrupt return, hampering the regular and uniform transmission of monetary policy across the area and severely limiting the ability of financial markets and institutions to smooth shocks across countries. Given the incompleteness of the European institutional architecture, the sovereign debt crisis called into question even the very survival of the single currency. While sovereign credit risk premia in the euro area have, over the last three years, been substantially retraced, European capital markets as a whole remain relatively underdeveloped and fragmented.

The importance of pursuing better integration of European financial markets has been emphasised in the report on *Financing business investment* recently delivered to the French Prime Minister by a task force led by François Villeroy De Galhau. Out of the 10 proposed policy recommendations, only 3 are targeted at the French context, while the other 7 call for European and international action.

As a result of the political push towards more diversified and integrated national financial systems, going forward, capital markets and non-bank financial institutions will have to take on a larger role in corporate financing in Europe and remaining obstacles to cross-border investments will have to be overcome.

The Banking Union and the Capital Markets Union should complement each other. I have often underscored the fact that the benefits expected from the CMU can be magnified by exploiting the complementarities between bank financing and market financing.

To begin with, banks can reinforce their central role in the financial system if they prove able to accompany the shift of part of the intermediation process from them to the markets by expanding their activity in the field of services and assisting firms in direct capital raising. Secondly, high quality securitisation, one of the CMU's short-term priorities, can effectively blend the banks' comparative advantage in screening and monitoring borrowers with market funding, allowing banks to free up regulatory capital, increase their lending and manage credit risks more efficiently.

In the same vein, broadening funding sources for firms provides benefits also to banks. Better access to non-bank financing, notably equity capital, improves firms' financial structure, supports innovation and makes them more creditworthy, thus safeguarding banks' balance sheets and avoiding vicious firm-bank loops.

This is not to deny that the CMU can put pressure on banks. By enlarging the pool of financial instruments available to households, the CMU creates incentives to allocate savings out of bank deposits; it may also contribute to narrow banks' margins on loans to households and firms, to the extent that borrowers gain access to a larger set of alternative financing solutions.

2. The challenges of the Capital Markets Union

The CMU is ambitious and prioritisation is the key to advancing it effectively. The Action Plan on Building a CMU, presented by the Commission on September 30, sets out both the actions needed to build the CMU and a calendar for their implementation.

Short-term actions range from (*i*) a legislative proposal to develop simple and transparent securitisation, possibly subject to favourable prudential treatment, through (*ii*) a revision of the capital requirements on investments in infrastructure for insurance companies, to (*iii*) the simplification of the Prospectus Directive (so as to facilitate listing for firms, especially SMEs). Consultations have been launched on cross-border investments in venture capital as well as on covered bonds, retail financial services and the impact of financial regulatory reforms.

These are all steps that go in the right direction, and we look forward to having them implemented in a timely manner. But the challenges are tougher over the longer term. Let me highlight what I think are the key policy directions and then I will move to the important topic of investment in infrastructures.

First, it is essential that more risk capital flows to firms that want to innovate and grow in size. Equity financing is best suited for higher risk and innovative projects, that display strong information asymmetries and mostly translate into intangible assets; the low availability or lack of tangible assets to offer as collateral for debt finance is a serious issue, especially for start-up firms. Equity can be raised through individual investors, venture capital or private equity funds, or, when a company matures, listing on a stock exchange. Private equity or venture capital financiers also provide managerial expertise and deeper knowledge of innovative sectors. Going public makes it easier to raise additional equity, reduces the cost of capital, enhances the discipline of firms' management and allows shareholders to sell their shares more easily. In the European Union, while the overall share of (listed and unlisted) equity on firms' liabilities is broadly comparable to that in the United States, only one third of this equity is accounted for by listed shares compared with slightly more than half in the US. As for venture capital, it represents a negligible share of firms' external finance, much lower than in the United States.

Firms' capital bases can be strengthened by pursuing a more neutral tax treatment of equity compared to debt, through, for example, an allowance for equity in corporate income tax. Such allowances could be strengthened for firms that list their shares on stock exchanges. Equity financing can also be supported by tax incentives, targeted for instance to innovative firms or venture capital investors. These are examples of measures that have been introduced in Italy in recent years.

Second, informational barriers about corporate borrowers, in particular SMEs, should be overcome. Financial claims on unlisted firms are typically risky and illiquid. They call for specific professional skills and information. Many investors thus need services and infrastructures to acquire and analyse the information necessary for risk assessment. The European Commission wants to facilitate the exchange of best practices in the (private or public) provisioning of advisory services to businesses looking to develop and grow. It is also planning to link up national information services on credit risk, such as central credit registers, in order to build pan-European information systems. Data standardisation will be facilitated by the ECB AnaCredit database on corporate loans, which is currently being developed.

Third, non-bank debt finance has to become a structural component of corporate financing alongside bank lending and equity. In a number of countries, including Italy, there have been national initiatives to promote the investment in, or the direct supply of loans to, mid-sized firms by long-term institutional investors and investment funds. Such initiatives should be coordinated. The private placement market is also gaining ground in some countries. This is a form of financing that allows firms to directly place their bonds with institutional investors and other qualified market participants at a lower cost than that of issuing securities to the public. Its further development requires process standardisation and a greater availability of information on credit risk to institutional investors.

Fourth, national laws on insolvency, tax and securities should become more homogeneous. In particular, debt finance would greatly benefit from a greater convergence of insolvency and restructuring proceedings across European countries. Potential discriminatory taxation rules should also be tackled. The harmonisation of national laws will inevitably be a gradual process. As also recently suggested in the Villeroy de Galhau Report on investment financing, we should not rule out any possible solution *a priori*, from the definition of common principles to the devising of a European solution (such as a European insolvency procedure). It will also be preferable to follow a modular approach, starting with the easiest reforms and then subsequently gauging where there is room to tackle more ambitious challenges.

Other very important policy actions included in the CMU proposal are the removal of market infrastructure obstacles to cross-border investment, the promotion of a European market for personal pensions plans, and the enhancement of the supervisory practices and macroprudential framework for financial markets.

3. Key issues that come up in financing infrastructures

The CMU is also intended to be a key support and complement to the EC Investment Plan for Europe. There is broad consensus that raising investment, notably in infrastructure, is a key priority to strengthen the recovery. At the same time, along with lending to SMEs, the financing of infrastructure displays distinct challenges that deserve outmost attention, notably the role and needs of institutional investors and the regulatory framework for long-term investment.

Infrastructure financing takes centre stage within the EC Investment Plan for Europe, which marks a first attempt to organise coordinated fiscal action to revamp investment in Europe as a whole. The overall size of the resources that will be raised by the Plan through its European Fund for Strategic Investments (EFSI) is a relevant but perhaps over-emphasised issue. What matters more is the ability of the EFSI to become a tool through which public and private resources can be channelled towards sectors that are important for productivity growth and job creation, such as infrastructures and SMEs.

The main challenge for the Plan comes from the demand side, i.e. the availability of suitable projects. Designing the construction and financing of a new infrastructure is a complex operation that takes time. In order to build a rich pipeline of bankable projects, the Plan introduces two specific advisory tools at an EU level, a knowledge hub and a project portal. These two initiatives are designed to facilitate the sharing of information and best practices and to enhance the matching of individual projects to financing options. They will be available for all investment projects, not only those that intend to seek funding from the EFSI.

Research carried out at the Bank of Italy on the Italian experience in Public-Private Partnerships (PPPs) since the mid-nineties highlights the difficulties that emerge in structuring these operations, due above all to pitfalls in the regulatory framework and limited availability of data. Improvements would arise from a systematic recourse to ex-ante analyses of risks, an appropriate standardisation of contracts, an in-depth monitoring of single operations and an improvement in the efficiency of public administration. It must be underlined that the preparation of contracts greatly benefits from the recourse to soft law instruments such as guidelines, standard documents and best practices, which testifies to the importance of several reports on PPPs that have been recently produced by the OECD, the World Bank and other international organisations and discussed at G20 level.

But there are challenges also regarding the supply of funding, i.e. the availability of financial resources for investments in infrastructures. Pension funds and insurance companies are types of "patient" investors that fit optimally for investing in infrastructure and long-term projects However, as the OECD and the EC have well documented, their exposure to infrastructures is limited.

In Europe, two important steps ahead have been recently taken. The European Long Term Investment Funds are dedicated cross-border fund vehicles that can be used by both institutional and individual investors to gain exposure to long-term projects. The EC's Communication of end-September makes another step forward by proposing measures to create infrastructure investments as a dedicated asset class that can thus benefit from more favourable regulatory capital requirements.

Another thorny issue with infrastructure financing is the lack of data. Recent OECD analyses, which also draw on studies conducted by national authorities including the Bank of Italy, suggest that the scant availability of comparable and sufficiently detailed data on infrastructures and related financing is a problem common to all G20 countries and applies to both the macro as well as to the micro level (i.e., firm or project data). We also need more information on the risk/return properties of financial claims on infrastructures. The OECD research on infrastructure as an asset class is particularly important, as it would help shed light on the riskiness of this type of investment compared with traditional asset classes and its hedging properties, especially in relation to the needs of long-term institutional investors such as pension funds and life insurers.

Concluding remarks

The Banking Union and the Capital Markets Union share a common goal: fostering investment and, ultimately, growth. Since its peak in 2007, gross fixed capital formation in the EU has dropped by about 10 percent in real terms. The need to support investment – national and European, private and public – in order to strengthen the recovery in the euro area, is paramount. Finance for growth has been one of the priorities of the Italian Presidency of the Council of the European Union in 2014. In many analyses the need to support investment stands out singularly as a shared priority.

The ongoing push to diversify the sources of financing for investment contributes to the building of a stronger and safer financial system. However, banks will generally remain the primary source of credit for non-financial companies, notably SMEs. It is thus paramount to continue all efforts in strengthening the European banking sector.

Completing the Banking Union is a priority. The Single Supervisory Mechanism (SSM) must be implemented across countries in a consistent way. The Single Resolution Mechanism (SRM) will be fully in place as of January 2016. Further progress is now proceeding or being discussed in three directions: ensuring a level playing field by addressing options and national discretions allowed for by the CRD/CRR; setting up a common public backstop to the new Single Resolution Fund; and establishing a common European Deposit Insurance Scheme. We have to move in these directions with the necessary care in order to avoid “unintended consequences” but at the same time without waiting for another financial crisis to occur.

The free movement of capital is a long-standing objective of the European Union, which dates back to the Treaty of Rome. The single currency, the Banking Union, and the need to relaunch investments and potential output make it as important as ever.

A stable, efficient and well-diversified financial system is also the result of effective structural policies. Both investment and investment financing flourish in sound economic environments. The rule of law, a low level of taxation on productive factors, competitive markets, efficient public administration and effective financial supervision, these are the basic ingredients of a system that is able to foster entrepreneurship and innovation, allocate resources to the most productive sectors and create good jobs.

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