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Reply to the European Commission on the Green Paper on Long-Term Financing of the European Economy

Assogestioni, the Italian Association of the Investments Management Industry, appreciates the Commission’s initiative and is glad to participate in the consultation on the Green Paper on Long-Term Financing of the European Economy.

Long-term investment plays an essential role in contributing to economic progress. In the following pages we provide some insights from the point of view of the Investment Management industry that we deem useful to tackle the challenge Europe is facing.

We are at your disposal for any further information and we look forward to contributing to the future work of the Commission.

Kind regards,

The Director General

1] Introduction

Economic recovery and sustainable growth need to be investment-driven. Investment leads to innovations that improve the competitiveness of businesses and markets and hence also to income growth and job creation.

In this context *long-term* investment plays an essential role in contributing to economic progress especially in the fields of infrastructure, urban development, renewable energies, small and medium-sized enterprises and innovation.

Strong increases in public debt and deficit levels imply that today in Europe there is less scope for government spending to provide the desired level of investment, in particular of the long-term type. Therefore there is a strong need to attract an increasing amount of *private* capital to offset the current and future decline in *public* capital availability.

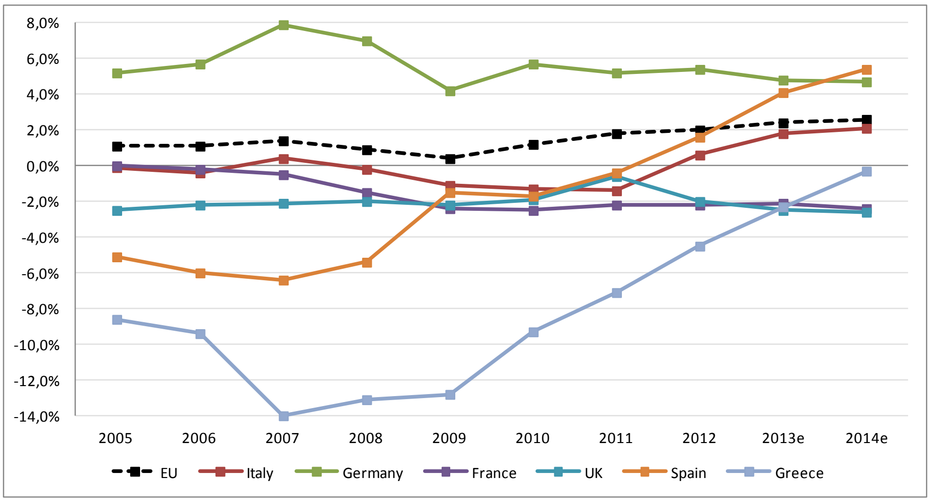
2] The supply of long-term financing and characteristics of long-term investment

Question #1: *Do you agree with the analysis out above regarding the supply and characteristics of long-term financing?*

At the European level the recent economic crisis resulted in a downward trend of both investment and saving rates, now at *similar levels* slightly below 20%. However the *aggregate* data do not reflect a number of differences among countries and in maturity structure, the latter being even more crucial to the current debate and in needs of addressing as a matter of urgency.

On the basis of Eurostat data, strong differences between countries can be noted. Germany has always been a ‘net saver’ as opposed to countries such as Spain or Greece. As a consequence of the current crisis, the latter have experienced a long and painful period of investment shrinkage that will likely represent a major setback for the future recovery of their economy (Figure 1).

Figure 1: Difference between savings and investments as a percentage of GDP. Source: Eurostat.

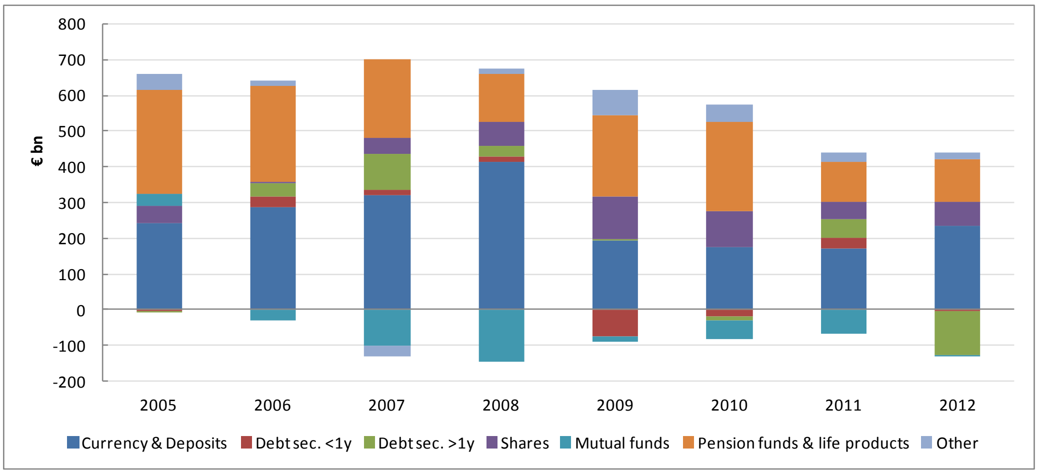


Under the perspective of maturity profile, given the positive externalities of long-term oriented investments, governments have always played a key role in their financing, using taxation and debt issuance to collect the resources needed.

Unfortunately, the strong efforts that many European countries are making in order to tackle high public debt and negative deficits will likely result in less (long-term) government spending for quite a long time. That will in turn increase the negative gap between the actual and the optimal level of long-term investments. To make things worse, the latter should also increase in order to better cope with an ever growing level of international competition.

On the other hand, households are expressing a strong preference for liquidity and are increasingly short-termist in their approach to investments: according to the euro area financial accounts flow data, during the last year households directed the bulk of their (shrinking) savings towards currency and deposits while disposing of more than 100 €bn of long-dated bonds (Figure 2).

Figure 2: Euro area aggregated household financial accounts. Flow data. Source: Eurostat.



All the above is progressively leading to a situation where a large timing mismatch will emerge between savings – that more and more investors want liquid – and long-term investments – that by their very nature are not suitable to meet this requirement.

Question #2: *Do you have a view on the most appropriate definition of long-term financing?*

According to the Green Paper 'long-term financing' is required in order to support investments in long-lived productive, *as opposed to financial*, capital goods given that the return from them can be harvested but only after a considerable period of time.

With this definition the Commission seems to play down the role of long-term *financial* investment by mixing the point of view of the economy with that of the end investors. Indeed it is well-known that *from the point of view of the latter*, a long-term commitment to remain invested in a given *financial* portfolio is by far the most common way through which long-lived productive capital goods are indeed financed.

In order to avoid a possible misunderstanding on this relatively simple point, we believe that the emphasis the Green Paper puts on the definition of long-term financing should be changed accordingly. For instance a clear distinction could be made between the economy, which is in strong need of long-lived *productive* capital, and investors, who need the best *financial* instruments and incentives to channel their savings towards this end.

3] Enhancing the long-term financing of the European economy

3.1] The capacity of financial institutions to channel long-term finance

Question #3: *Given the evolving nature of the* ***banking sector****, going forward, what role do you see for banks in the channelling of financing to long-term investments?*

In the aftermath of the financial crisis, banks have been rationalizing their business models by tightening credit standards and adjusting to market and regulator demands for more and higher quality capital. As a consequence there is a large consensus on the view that the future involvement of the banking sector in long-term financing will not resume to the relatively high pre-crisis level.

However we believe that the future role of banks in the European economy will still be prominent for a long time and for at least three reasons.

First, bank loans currently account for the bulk of outstanding non-financial corporate debt: according to the same Commission Staff Working Document for a figure close to 85%. While it is set to decline, it will likely do so at a slow pace, at least in the foreseeable future.

Second, in many European countries the banking sector plays a central role in the financial product distribution system: any new way of channelling savings from retail investors to long-term projects will probably heavily rely on banks, albeit under a different framework (intermediation rather than own account).

Finally, the expertise banks have acquired in the evaluation of creditworthiness of long-term projects will likely be important even in the development of new *non-bank* financing vehicles for that target.

Questions #6 and #9: *To what extent and how can* ***institutional investors*** *play a greater role in the changing landscape of long-term financing? What other options and instruments could be considered to enhance the capacity of banks and institutional investors to channel long-term finance?*

In the context of institutional investors there is a fundamental trade-off between *client liquidity* (i.e. the ability of the end investor to transform investment into currency in a relatively short time) and *portfolio maturity* (in this context to be construed as its exposure to long-term illiquid investments).

This trade-off is reflected into the investment regulation of the different products that are available on the market. In this perspective a general distinction can be made between *insurance companies*, *pension* and *closed-end funds* on one hand and *open-end funds* on the other.

Due to the long duration of their liabilities, the former could build, at least in theory, an investment portfolio with long-dated *illiquid* assets. In contrast, the ability of the latter to invest in the same way should be (and actually is) severely restricted in view of their general obligation to fulfill redemption requests *at any time*.

As a matter of fact both insurance and pension provision regulations are moving towards market-consistent valuations and risk-based solvency standards that could negatively affect their ability to act as long-term investors. That calls for a careful consideration of both the process of calibration of Solvency II capital requirements and the future review of IORP Directive in order to make sure that no *unnecessary* obstacle to long-term financing is being introduced.

As regards investment funds, it is straightforward that closed-end products are the first-best option to provide for long-term financing of the economy. However, taking into account that the bulk of the European fund market is represented by open-end funds, we believe that such products should be specifically considered in this context as well.

In particular today UCITS funds account for more than 70% of the 9,000+ €bn European industry. With reference to their possible contribution to the financing of long-term investments, it has been observed that the more risk-oriented tier of the market (e.g. equity and high yield funds) could play a role by making use of the 10% unlisted (i.e. *illiquid*) securities allowance granted by the Directive.

However the point has also been raised that this limit is too tight to allow the development of a full-scale long-term investment fund market in the context of the *current* UCITS Directive framework.

To address this issue it has been suggested to increase the 10% limit or even to drop it altogether; however we believe that this is neither appropriate, nor necessary.

In fact, this threshold is at the root of UCITS regulation and in particular of its distinctive openness feature. Lifting its value would result in introducing a substantial liquidity risk in the redemption process, which in turn would create confusion among investors and endanger the UCITS brand which is recognized as a quality label worldwide.

Instead, we suggest developing a common EU regulatory framework that moving from the UCITS experience would allow for the creation of funds specifically dedicated to long-term financing. Should this new framework be developed as a new category of product within the existing UCITS Directive or as a separate stand-alone regulation, it shall provide for asset eligibility, redemption and borrowing rules appropriately chosen to best balance the long-term approach of investment policy with the liabilities features of the product.

In particular, the scope of eligible assets shall be broadened beyond the current UCITS rules. For instance, long-term funds (LTFs) should be allowed to invest in infrastructure, urban development projects, renewable energies, small and medium-sized enterprises and bank loans.

Redemption rules shall be strictly calibrated to the structure of the portfolio. As a general rule a rise in the weight of illiquid or long-oriented investments should be appropriately matched with a consistent reduction of liquidity liabilities of the LTF through the provision of (longer) lock-in periods or restriction to access to early redemption provision, if any.

Finally, explicit albeit limited borrowing powers shall be awarded to LTFs in order to gain access to an appropriate level of leverage but also to be in the position to smoothly manage the liquidity provision.

A specific regulatory framework would increase LTFs visibility and attractiveness. In addition we deem crucial for their success that they are also granted valuable tax benefits targeted to raise the interest of short-term oriented retail investors. Should they eventually decide to trade the liquidity of part of their savings with the participation in the long-term investment of the economy, the cost of the tax breaks would be likely fully repaid in the mid term.

Should the Commission decide to work towards the development of the proposed LTF framework, we stand ready to give our full support with a further detailed analysis.

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

Questions #11 and #12: *How could capital market financing of long-term investment be improved in Europe? How can capital markets help fill the equity gap in Europe? What should change in the way market-based intermediation operates to ensure that the financing can better flow to long-term investments, better support the financing of long-term investment in economically, socially and environmentally-sustainable growth and ensuring adequate protection for investors and consumers?*

Policy makers intent on unlocking new sources of long-term finance should foster the growth of new markets and instruments that can help fill the gap between the current sources and projected future demand for long-term investment.

While US bond, equity, and securitization markets are mature and liquid, this is not the case in much of the rest of the world. Hence banks are and will remain for the medium term the dominant source of external financing outside the United States. However commercial bank loan maturities average only 2.8 years in emerging economies and 4.2 years in developed economies—far shorter than bond maturities.

Over the medium to long term, there is large scope to increase the size of corporate bond markets in Europe, in several other advanced economies, and in emerging economies so that they could complement the continuing important role that banks must play. For example, according to Group of Thirty estimates, if companies with more than US$500 million in revenue in Canada, France, Germany, Italy, Spain, and the United Kingdom were to obtain 80 percent of their credit from bonds rather than loans—less than what we observe in the United States for companies of this size—the corporate bond market could potentially grow by US$2.7 trillion, or 32 percent, over a long period of time.

Bank lending will remain an important source of financing in Europe. However, with the right standards and regulations in place, more small business loans could be packaged into securities and sold to investors, enabling banks to extend more credit.

Prudent growth of new bond, securitization, and equity markets, adequately overseen and supervised, must be part of the solution to the long-term finance problem.

3.3] Cross-cutting factors enabling long-term saving and financing

Questions #15 and #17: *What are the merits of the various models for a specific savings account available within the EU level? Could an EU model be designed? What considerations should be taken into account for setting the right incentives at national level for long-term saving? In particular, how should tax incentives be used to encourage long-term saving in a balanced way?*

In our reply to Question #2 above we suggested that from the point of view of the end investor a long-term commitment to keep its savings invested is by far the most common way through which long-lived productive capital goods are and could increasingly be financed.

Taking into account that taxation influences considerably investment decisions, we believe that setting specific cost-efficient tax benefits that favour long-term commitment of savings is an *essential part* of the general plan to foster the long-term financing of the European economy.

Consistently with this view, a few European countries have already granted retail investors tax relief when investing in the long-term: Individual Savings Accounts (ISA) in UK and Plan d'Epargne en Actions (PEA) in France are two major examples.

Since 2011 the Italian law generically provides with a long-term investment related tax break. However the implementing and detailed regulation is still lacking and as a consequence it has not been applied yet.

In this context Assogestioni has published a proposal on how the Italian saving plans could work in practice. The 'PIR' (Piani Individuali di Risparmio) solution combines elements of the French solution and the UK ISA and could be the basis for building a European standard. It could also be assumed by those Member States that still do not have such a regulation in their tax code.

In particular, in order to be eligible for the tax reduction a PIR account must be opened by a retail investor with an intermediary (e.g. a bank, an investment company or an asset management company) for such specific purpose.

Income and capital gains from investments made through a PIR shall be taxed at a rate lower than the ordinary one provided savings are held in the plan for at least five years. Higher tax discounts shall apply to longest holding periods (as in the case of French PEA) and the highest benefits shall be granted after a holding period of ten years or more.

Once in the PIR, savings can be invested in a full range of financial instruments: equities, bonds, investment funds, insurance products and even cash. Should diversification or liquidity features be desirable, a set of investment compliance rules could be introduced accordingly.

It is important to note that PIRs are long-term *savings* plans but not necessarily long-term *investment* plans. Indeed the portfolio composition can be changed at any time and provided savings are kept into the account, they will retain the tax privileged treatment. However there should be no restriction on when or how much money can be withdrawn from the plan.

Finally, in line with the French and UK plans, each fiscal year PIRs may receive only a limited amount of money; should this limit be passed the surplus will not be granted any particular tax benefit.

3.4] The ease of SMEs to access bank and non-bank financing

Questions #26 and #29: *What further steps could be envisaged, in terms of EU regulation or other reforms, to facilitate SME access to alternative sources of finance? Would an EU regulatory framework help or hinder the development of this alternative non-bank sources of finance for SMEs? What reforms could help support their continued growth?*

The declining availability of bank finance calls for a prompt policy action to promote the development of alternative, non-bank channels for SME financing. To this end, both debt and equity capital markets should play a key role. In this perspective a couple of interesting initiatives have been recently launched in the Italian market.

In 2012 Consob, the market watchdog, together with the most prominent finance and industry associations, launched an action plan named "PiùBorsa" consisting of a number of commitments and activities aimed at improving SMEs access to the equity market. In fact, these companies, which represent the bulk and, in many cases, the most innovative tier of the Italian production system, are strongly under-represented in the stock market compared with their role in the economy and still account for only a very small fraction of listed companies.

According to the plan details, education and SME scouting activity will be incremented thanks to a better coordination of current and future initiatives: the Italian Stock Exchange 'Elite' project, the definition of guidelines to make prospectus production and post-IPO rules compliance easier, the launch of partnership among the associations involved in the plan for the purpose of giving a further boost to the scouting activity of companies potentially interested in tapping the stock market.

Consultancy and assistance in the listing process shall be improved by making easier to identify service providers and compare their costs. In addition specific post-IPO assistance shall be granted to SMEs accessing the program, including reduction of standard market and regulator fees, red-tape reduction through a single facility taking care of all formalities connected with listed status, promotion of services associated with on-going trading such as organization of road-shows, production of financial reports (equity research) and assistance for liquidity-providing activity.

Finally a specific plan for promoting SME-related asset management products has been devised: a fund of funds project is being developed aimed at collecting resources from institutional investors (foundations, insurance companies, pension funds, government and regional entities) and at subsequently investing them in funds/vehicles devoted to small caps.

Investment of part of the assets of *existing* open and closed-end funds in listed or about-to-be-listed SMEs is being encouraged thanks to the efforts of Assogestioni. At the same time an increasing number of management companies are considering the institution of *new* funds specialized in SME investment as a way of expanding their range of products and give a positive answer to the mounting demand for alternative financing solutions coming from small and medium Italian businesses.

In 2012 a legislative initiative has introduced a new sound and tax efficient framework for developing alternative financing instruments for Italian *non-listed* companies. The new legislation aims at facilitating the issue of short-term debt (commercial paper) and mid to long-term debt (notes named 'mini bond' for the occasion) by these entities for which the previous regime was considered too penalizing.

In particular, the strict quantitative limit to the amount of notes a non-listed company could issue under article 2412 of the Italian Civil Code has been removed, provided the notes are (or are expected to be) listed on a regulated market or a multilateral trading facility (MTF).

In addition, the taxation regime for notes issued by unlisted companies has been aligned with the more favourable regime for listed companies. In fact, to make notes a real alternative to loan financing the new law has introduced provisions that, on one hand, make the issue more tax-efficient for the issuer and, on the other, should increase the interest in those financial instruments for potential investors.

In particular, regarding the *issuer* the law aligns the rules relating to the tax deductibility of interest expense on notes issued by unlisted companies with the regime that applies to listed companies, provided that the subscribers of the notes are qualified investors who are not the direct or indirect shareholders of the issuer. In relation to the tax regime that applies to the *investors* the same law extends the exemption from the 20% withholding tax on interest and other proceeds to notes issued by unlisted companies, provided that the notes are traded on a regulated market or on an MTF.