COMMITTEE ON
Global Thought
COLUMBIA UNIVERSITY

Sovereign Wealth Funds and Other Long-Term Investors
New York, Columbia University, October 4-5, 2010

A New Regulatory Framework for Financing Long Term Investments: a View from Europe

Key Note Speech

Franco Bassanini
President, Astrid Foundation
Chairman, Cassa Depositi e Prestiti

Ladies and Gentlemen,

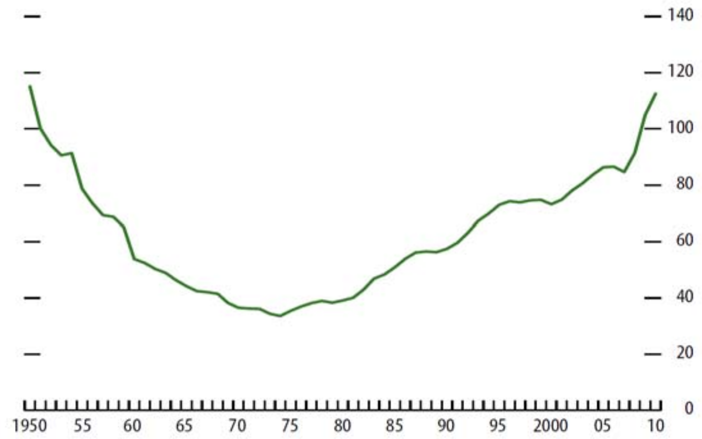
My talk will be focused on the long term investments in strategic sectors for growth, competitiveness and social cohesion - like infrastructures, environment, research, biotechnologies and energy - and the role of long term investors, from a European perspective.

* * *

As you know, after the 2008 crisis, public finance of advanced economies is under stress. The level of public debt/GDP ratio of G-7 countries soared to post-war levels. For the "advanced economies" within the G-20, this ratio peaked to 102% in 2009 and is expected to reach 122% in 2014.

Cassa depositi e prestiti spa

Sovereign Debt to GDP (%) in the G-7



Source: IMF, *Global Financial Stability Report*, April 2010.

2

Public budgets are debilitated by the recession, and drained by the government interventions to save financial institutions and other sectors weakened by a waning economy.

Cassa depositi e prestiti spa

Financial Support Operations in USA, UK and Europe

	Capital injections	Guarantees	Other	Total	N. of Financial Institutions	Bought and/or Given Back	Net	N. of Financial Institutions
USA	367	1.197	97	**1.662**	**702**	402	**1.260**	78
UK	86	704	3	**362**	**13**	68	**294**	2
Europe *	188	512	25	**1.156**	**102**	117	**777**	9

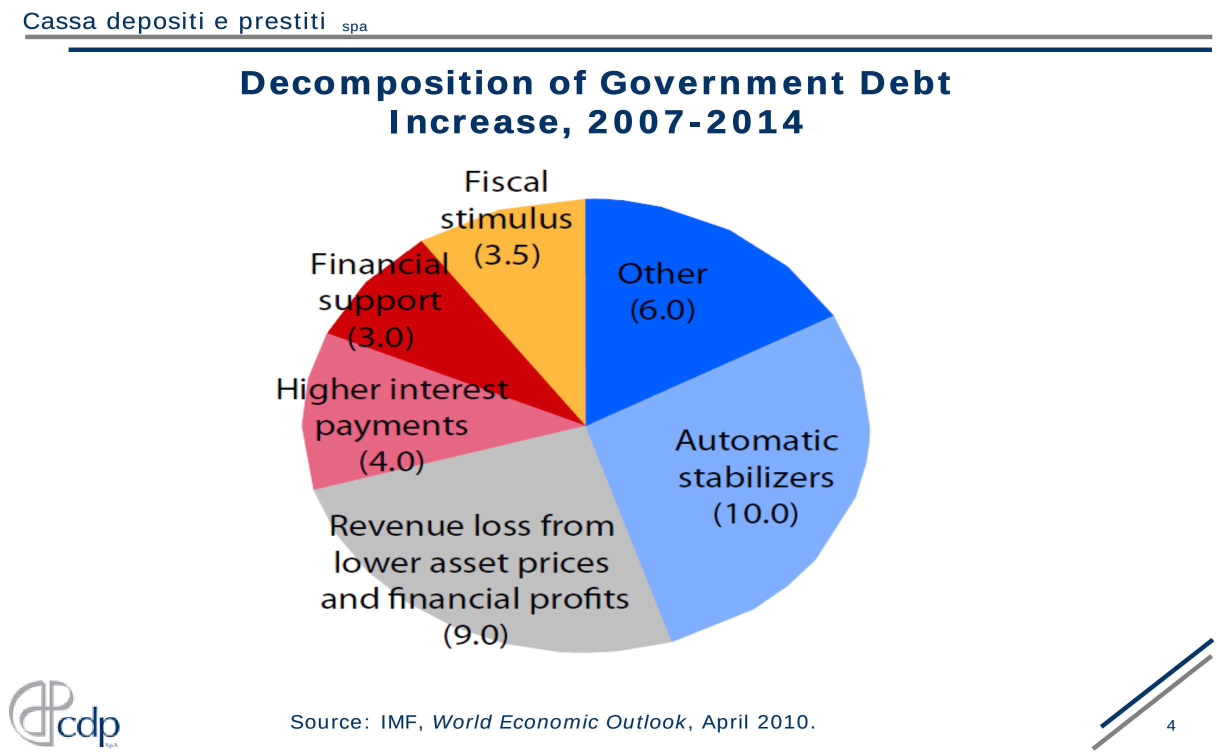
(*) Europe includes: Austria, Belgium, Denmark, France, Germany, Greece, Ireland, Island, Italy, Luxemburg, Holland, Portugal, Spain and Switzerland.

Source: R&S Mediobanca, May 31st 2010.

5

C0nsidering the 33 advanced economies as defined by the *World Economic Outlook*, in 2009 the budget deficit averaged about 9 per cent, up from only 1 per cent in 2oo7:

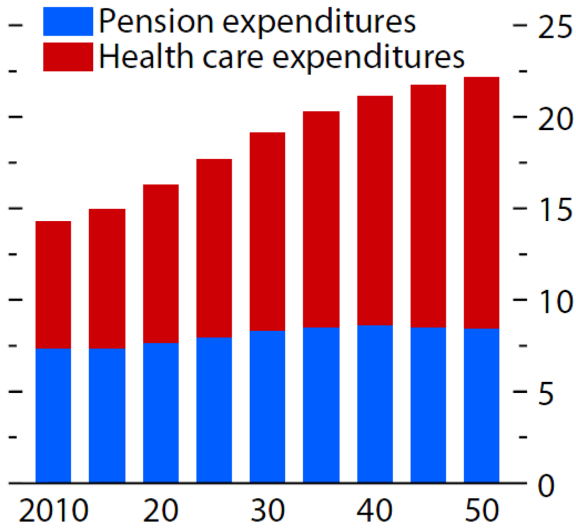
According to IMF, 10 to 15 years of fiscal adjustment are needed to return to pre-crisis levels of public debt. Revenue losses, automatic stabilizers, and higher interest payments constitute the main part of government debt increase.



Then, most advanced economies need to lower their deficits and their debt substantially. Some are already experiencing strong financial market pressure to do so.

Moreover, in the coming years the debt reduction will have to face the negative effects of low growth rates and the increasing costs of the welfare state, in a society which supports a growing population of aging citizens.

Ageing-Related Spending in G20 Advanced Economies



Source: IMF, *World Economic Outlook*, April 2010.

* * *

The problem therefore is "structural" not just cyclical.

Restoring sustainable debt over the medium term will be indeed a very challenging task.

Strong inflation could reduce public debt. But high inflation seriously distorts the allocation of resources, reduces the growth rate, hits the poorest citizens, creates social and political instability. Moreover, once unleashed, inflation is hard to contain. Then, price stability must be maintained and Central Banks should work to ensure it.

Major cuts in public spending are necessary, but politically difficult. In the long term they may seriously jeopardize the political consensus of Governments.

Together with relevant but sustainable cuts in public spending, increasing the average rate of GDP growth is then the most desirable solution to restore fiscal stability.

It is not easy to achieve. Reforms to liberalize markets, boost competition and cut regulatory burdens are always necessary, but, alone, have shown not to be able to achieve the desired results as yet.

* * *

A further demand-side boost for the economy, like to the one recently enacted by the United States and Chinese governments, could represent a partial solution.

Investment in strategic sectors – like infrastructures, research and technological innovation, environment, alternative energy sourcing, biotechnologies – could foster economic growth and enhance competitiveness and productivity. These are all sectors which themselves may yield high investment returns, stimulate follow-on investment and, as a result, create growth and jobs. So, their annual contribution to the growth rate of per capita GDP might be substantial in magnitude.

Furthermore, these kinds of investments should play a central role in shifting European growth, increasing the quota based on “public and common goods” (which generally reduce CO2 emissions) and decreasing the quota produced by “consumer goods” (which generally increase CO2 emissions).

In fact, the demand for infrastructure, energy, climate change, strategic and urban infrastructure in Europe is very large. It is estimated at over 3,000 bn euro in the next ten years.

During the so called “Golden Age” (1950-1973) annual growth rates in Europe exceeded 5%. Public debts levels - stationary under 50% of GDP - were highly sustainable. Such strong rates of growth were possible thanks to very high level of investments in infrastructure.

Investments in green economy may play the same role in the next decades.

* * *

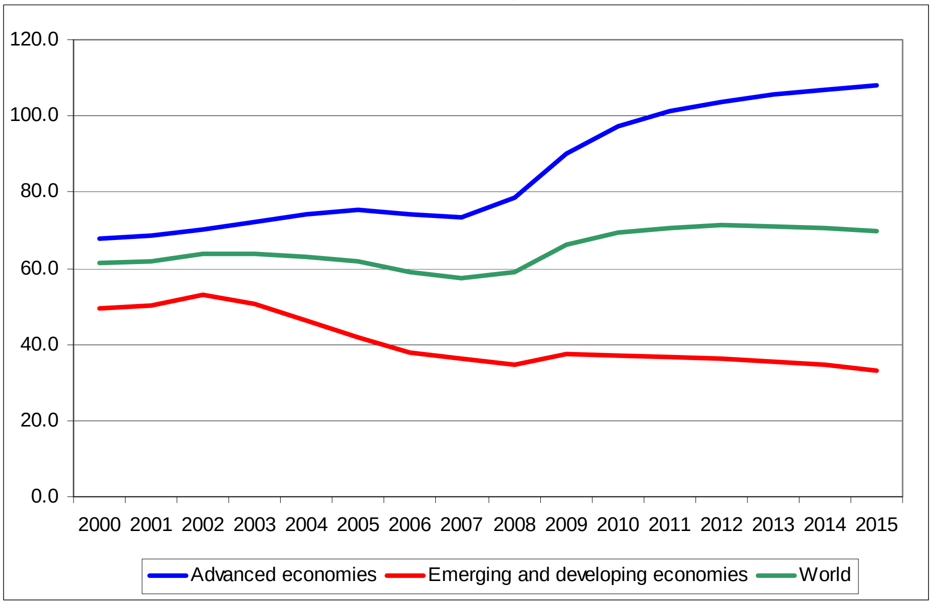
Therefore: the most desirable solution to reduce EU public debt to GDP ratios and restore fiscal stability is to increase the average growth rate; a feasible way to stimulate growth is to channel major flows of long-term capital in regional and cross-border initiatives, with strong positive externalities for the economic system and social cohesion.

But, where do we get the resources to finance such ambitious regional and cross-border programs of long term strategic investments? Increased government deficits required by the recent crisis imply that government spending cannot, under actual macroeconomic conditions, provide the desired level of investment.

It is clear that the European countries will not be able to finance such investments mainly with their own budget resources as high growth and low public debt countries (such as China, Korea, Russia, Australia) can do (and decided to do).

Cassa depositi e prestiti spa

Public debt (% of GDP)



Data source IMF, 2010.

cdp

8

Therefore, Europe, should enact policies to raise (to attract) capital from the private sector and from extra European public and private sectors for financing European strategic investments.

* * *

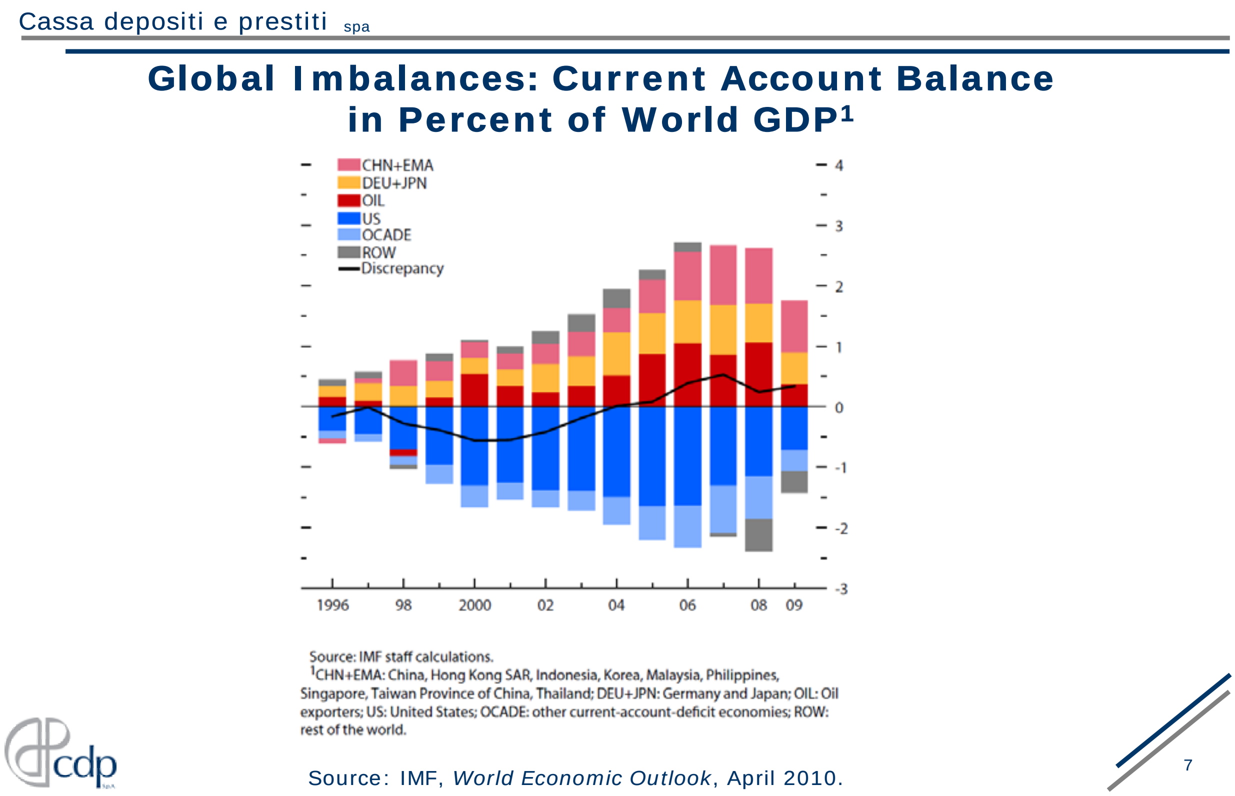
Historically Europe has high household savings rates. The Household savings may be a very important asset.

With new rules, incentives and financial instruments, Euro denominated investments could became more attractive also for financial capital surplus countries searching a way to diversify their asset allocation. I think especially to low public debts emerging countries such as China, Singapore, Russia, Arab Gulf Countries, India, Brazil, Mexico, Saudi Arabia.

The world economy is experiencing changes in both saving and investment behavior, which are having implications for the configuration of current account (CA) imbalances. After the Asian Crisis (1997), CA surpluses were favored by weak currencies in developing Asian countries and Newly Industrialized Countries and by strong economic growth in China.

Moreover the increase in commodity prices after the crisis recessionary period helped to generate surplus in oil-exporter countries. After 2000, surplus in Asian Countries and oil-exporters proved to be persistent: Gross domestic savings at pre-crisis levels with declining investments. CA surpluses were supported by exchange rate policies: rates at competitive levels with respect to pre-crisis period, in order to benefit form export-led strategies and to accumulate international reserves as buffers against future financial crisis.

In the first years of 2000s, equity prices played an equilibrating role in international financial markets. In particular, the expectations of future productivity growth in US attracted capital from emerging market savers, which flowed in US causing an increase in stock prices and a appreciation of US-$. Moreover, under a generally accommodating monetary policy in advanced countries (especially in US), low interest rates, and a strong emerging countries growth (China), the overall deficit rose for advanced countries after 2004, with Eastern Europe deficit adding to total world demand for excess savings.

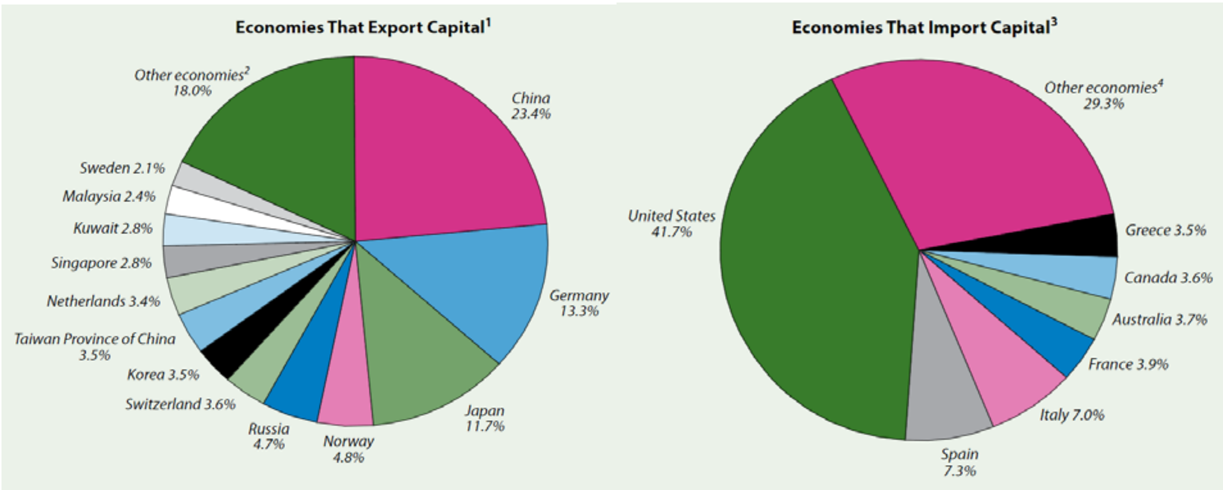


Global imbalances nearly halved during 2009-10 as a result of the crisis, with a marked decline in the United States' deficit and in the surplus of the oil-exporting countries. Fiscal consolidation tends to follow current account reversals on the basis of previous experience and will be much needed in some countries as a result of a massive build-up of government debt related to the global crisis.

Thus, this process could favor a rebalancing of capital flows from surplus to deficit countries towards corporate bonds, equity and/or foreign direct investment. As recently shown by OECD Economics Dep, current accounts imbalances in the next decades - to the extent that they reflect increased financial integration and a more efficient allocation of global savings – may become a source for financing long term strategic investments.

Cassa depositi e prestiti spa

Major Net Exporters and Importers of Capital in 2009



Source: IMF, World Economic Outlook database as of March 10, 2010.
[1]As measured by economies' current account surplus (assuming errors and omissions are part of the capital and financial accounts).
[2]Other economies include all economies with shares of total surplus less than 2.1 percent.
[3]As measured by economies' current account deficit (assuming errors and omissions are part of the capital and financial accounts).
[4]Other economies include all economies with shares of total deficit less than 3.5 percent.

cdp

8

* * *

Of course, this shift in the international capital allocation can take place only if the return-risk profile of new and different instruments of public or public-private securities will fit the preferences of long term investors and international savers.

International capital flows can match the long-term exit-strategy policy mainly based on strong investments in infrastructure (see for instance the Obama's infrastructure plan and the EU "2020" strategy).

We expect that the global demand for infrastructure will grow rapidly in the next year. For instance, the overall cost of the Trans-European Transport Network (TEN-T) still to be financed has been assessed at around 500 millions euro by 2020. The overall cost investments in Energy and Climate Change is estimated in over 2,500 billion by 2020. It includes energy infrastructure, energy generation, renewable energies, and environment systems and infrastructures.

Investing in infrastructures requires a long-term perspective, due to the time horizon of projects realization. As far as they are productivity-enhancing, large scale infrastructural investments contribute to lung-run economic growth. At the same time, they express their potential returns only after several years. These kind of investment are mainly related to the improvement of the business and consumer environment, by modernising the interconnection framework, by lowering the transport costs, and by supporting the green economy, among other things.

Long-term investment may also induce sustainable growth, employment and global stability. It generates stable cash flows over longer periods and financially sustainable long-term risk-adjusted rates of return. In developed financial markets, long-term investment is usually countercyclical and thereby mitigates volatility, stabilizes the economy, and sustains growth. In presence of credit constraints, however, long-term investment can face a higher liquidity risk and weakens, sometimes, the solidity of the industrial and banking sectors.

* * *

How to attract this capital?

To support long term investments, public and private sector must work together to build strong "complementarities": new forms should be explored.

New rules and incentives for PPPs and PFIs and new EU endorsed financial instruments should then be introduced: a European framework for financing Public-Private Partnerships proposing specific financing vehicles with appropriate valuation rules, the units of which should be traded on a secondary market. This framework would also facilitate off-balance sheet commitments for public authorities and encourage the creation of public guarantee structures to reduce the risks borne by private investors regarding the profitability of long-term infrastructure projects, which can only be taken on by public authorities.

A new regulatory framework - more friendly with long term investment or, at least, not discriminatory against it - is also needed. It should involve accounting standards, prudential principles, and corporate governance, as well as "ad hoc" systems of fiscal incentives, as proposed by the de Larosière Group Report on Financial Regulation and Supervision and, very recently, by the Eurofi Conference held in Brussels last week and by four European Long Term Investors (EIB, KfW, CDC and CDP) with a paper presented to the EU Commissioner Michel Barnier on September 30th in Brussels

As for the tax systems, in many European Countries the strategic long term investments are disadvantaged compared to financial short term investments. It seems to me that, above all, these discriminatory tax disincentives should be abolished.

Considering the important positive externalities of the strategic long term investments, we may moreover think to introduce "ad hoc" incentives for financial products and firms that invest in the long-term initiatives of general interest, on the lines of the fiscal incentives granted to the US Project Bonds by the American Administration Stimulus Plan and of the incentives awarded to the renewable energy projects by many European tax systems. Following the same logic, however, higher tax rates are frequently provided for the selling back of real estate assets bought few years before (usually 3-5 years), presuming a speculative transaction.

The fiscal incentives could go directly in favour of the long term investors. Financial institutions can be eligible for incentives if they decide to hold part or all of their assets as long-time investments in the strategic sectors.

Tax expenditures for long-term investments should not be considered in the Maastricht criteria. More generally speaking, in the rethinking of the European Growth and Stability Pact, some kind of new "Golden Rule" should be applied to the duration of investments. Long term strategic investment with over 25/30-years time span, and/or the related guarantee schemes, should be considered not under primary spending, but as a fixed investment having a special accounting treatment within the European statistical framework.

* * *

As for the accounting standards, the "mark to market" principle, if applied to typical long-term investors, does not permit distinctions between short-term and long-term investment values in balance sheets. There is need to i) introduce accounting criteria that reflect long-term investors specific business model; ii) distinguish between different temporal durations/matching liabilities and investments; and ii) take into account the value of future cash flow over the long-term.

Appropriate accounting rules for long-term investors would also make a substantial contribution towards stabilising global financial markets and reducing short-term volatility.

The prudential treatment of financial assets giving priority to their mark to market value is standing in the way of long-term investment. The mark to market accounting rules applied to typical long-term investors do not incorporate in their ALM distinctions between short-term and long-term investments. Therefore, a change in the prudential principles might be recommended.

Due to the mark to market rule, the contingencies affecting the value of these investments over the short-term are having repercussions over time on the financial statements – higher earnings volatility and additional solvency requirements – although the actual horizon for these investments goes beyond that for the publication of the accounts.

Within the new Basel proposals on capital adequacy, there can be identified the following main issues as potentially creating a disadvantage for long term investments:

(1) the treatment of participations: Deduction from the capital base of "financial" equity holdings and minority interests in non-bank subsidiaries;

(2) the pro-cyclical effects of the inclusion in the capital base of unrealised gains and losses, the limited recognition of deferred tax assets, and the additional capital charge for counterparty risk.

As to the new Basel proposals on liquidity regulation, we must consider that the Long Term Investors have a better quality of maturity match between their assets and liabilities. In the event of financial crisis, Long Term Investors are likely to be the beneficiary of a "flight to quality" rather than suffer a damaging run from risk.

The demand for their loans is more predictable. For example, their future commitments to say project finance mean that undrawn commitments can only be called in accordance with a contractual schedule – unlike the classical banking revolving credit where the whole undrawn element can be called instantly. These characteristics should be recognised in the regulations. In fact, not only is long-term investment not enough promoted, but current rules induce long-term investors to behave following a short-term perspective.

Also the theory of finance is looking for new dynamic risk management models for these long-term type of investors.

* * *

As for the European new financial instruments, usable for attracting private capital and public/private foreign capital in long term European strategic investments, a first example is the "2020 European Fund for Energy, Climate Change and Infrastructure (Marguerite)", a pan-European equity fund for investment in energy, climate change and infrastructure, set up recently by six public banks, following a suggestion of the Italian Finance Minister Giulio Tremonti.

It was endorsed in December 2008 by ECOFIN and the European Council as a key measure of the European Economic Recovery Plan (EERP). It could become the prototype of a "family of European Funds for Growth" to support the market in financing the objectives of the Lisbon Agenda.

The Marguerite Fund is in fact a good example of "reinforced cooperation" in the European financial sector, although not a cooperation among EU member States, but among some long term investors totally or partially owned by the EU member States. Other equity funds (like Inframed) have been launched by the same institutions or are in their pipeline.

Other common financial instruments to make more attractive European project finance initiatives should be considered, such as Project Bonds and Guarantee Schemes. The Projects Bonds issued by the Marguerite network's Funds could in fact anticipate the Eurobonds that meet yet strong however declining political resistances, specially from the German side.

The “reputation premium”, which may come from the EU endorsement and from the “high standing” of the long term institutions involved, as project sponsors, may decrease the cost of financing of these large PFI initiatives.

Increasing the credit ratings of the financing instruments could create an asset class which may attract large institutional investors from different regions of the world.

* * *

As many OECD Reports have shown, private and foreign investment in PPP and PFIs require also a good and stable regulatory framework, with sustainable regulatory and bureaucratic costs, efficient civil service and government services and a reliable judicial system. In many European Countries (including Italy), better regulation is the first requirement for attracting private and private/public foreign strategic investment.

Independent authorities are needed both for enacting proper rules and regulations not subject to the politicians’ fickle interest and will, and for assuring an impartial enforcement of these rules.

A good example could be offered by Italy, where relevant investments are required in some utilities sectors such as water supply, waste disposal and incinerators, but are discouraged by the lack of an independent regulatory authority, assuring proper rules and rates.

* * *

The short-termism that characterized recent global capitalism had negative effects on the economy and the global financial system. The so-called “shareholders’ capitalism” created strong incentives to maximize short-term, rather than long-term, value. Indeed, the managers of the firms are “winners” if they maximize the value of the shares, which is directly related to generous bonuses and stock options. The excess of liquidity originated in the 1970s with the “petrodollar”, coupled with deregulation of financial markets and institutions, exacerbated arbitrage and short-term speculation.

In the past, the Western financial system was based on the strict institutional partition between “banking” and “securities” Over the last decades, socio-economic evolution and technological innovation favored the legal breaking up of market segmentation and the creation of financial conglomerates and giant financial institutions. Deregulation brought typical “banking risks” into “objectified capital markets”. The abolition of the Glass-Steagall Act led to a tremendous increase in the securitization process carried out by financial institutions, many of which was previously concentrated in banking activities.

We therefore may have to rethink the foundations of such a conceptual apparatus, by rebalancing the incentives mechanisms in order to favour the long-term stakeholders’ interests, instead of the short-term shareholders’ values.

* * *

Ladies and Gentlemen,

The European Union’s increased need to attract a large volume of financial resources from global markets in support of strategic investments is essential to securing the region’s elite status in the fields of knowledge, technology, environment, culture, social cohesion and civil progress.

Long term investments in major infrastructure projects represent also a key part of the European exit strategy from the crisis. Europe can stimulate growth in coming years by investing heavily in energy, the environment, transport and telecommunications, and making use of innovative, long-term financial instruments that do not burden public finances and consequently, future generations. Important moves to lift the economy out of recession would then be: (1) boosting GDP growth in sectors that ensure “strong, sustainable and balanced” economic growth, (2) reducing investment spending that weighs on public finances; (3) generating major positive externalities for the economy, the environment, and social cohesion; and (4) helping to readjust public finances through renewed growth in GDP and, consequently, revenues.

However, the binding budget constrains prevent most EU countries, heavily weighted down by the crisis, from financing these investments with public resources. Therefore, to finance such an ambitious program the EU needs to increase its capability to attract long-term private and public-private capital from global markets. In this framework, the importance of the European institutional long-term investors and development banks (such as the EIB, the German KFW, the French CDC and the Italian CDP) is going to rise in the coming years.

The EU should then set up a special agenda including a revised regulatory, a special accounting and fiscal framework for long-term investments in strategic sectors, a new , reinforced role of the European institutional long-term investrors and development banks, as well as the creation of new long-term instruments for financing infrastructure (such as EU equity funds, project bonds and common guarantee schemes).

In fact, without substantial changes in prudential, accounting and tax regulations, the objectives set in the EU 2020 Strategy and in the Mario Monti report on the Internal Market strategy could not be reached. Appropriate prudential, accounting and tax rules for long term investments and/or investors (as proposed by the de Larosière Report, and, recently, by the 2010 Eurofi Conference) will give a substantial contribution to the promotion of long term public policies. Augustin de Romanet told us this morning that these proposals will be supported by the French Government and will be included in the G20 Agenda of the next French Presidency. The Italian Government shares this proposal.

* * *

Some of the points of this EU Agenda are in the hands of politics. Others are only partly in the hands of politics, since a complex system of contrasting interests and organizations is at work as for Basel III and the International Accounting Standard. All these different actors have a role in the process of modifying the accounting standards, at a European and global level, to favor long term investments. Striking the best balancing point is not an easy task, even for politics.

Of course, the technical rules must be developed by specialized independent organizations. But the general framework of rules and objectives to guarantee common goods and public interest is a task of political authorities .

After a long phase were finance and economy were setting the rules of the game now politics needs to came back at the center of the stage in this complex system of multi-level governance. I believe that politics, the public power, should gain back the primacy of the decision making process, at least for the time needed to change the rules of the game.

For too long now we have let the market alone decide; now the time is ripe to let politics come back to re-design the rules for a better future for this and for next generations.

Thank you for your attention.