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Long Term Investments
The European Answer to the Crisis

Towards a New European Policy of Value Creation for Future Generations: the "Marguerite" Network

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The issue of long term investments is one of the most relevant keys for the future of Europe and for the future of world economy. It may play a positive role for the financial markets' stability. Moreover, it is crucial for long term planning of economic and social systems.

A long term policy is needed for facing the great long term challenges of our society, including demographic change, scarcity of natural resources, environment protection and climate change, growing poverty worldwide, immigration, education and research. A long term policy framework must be based on strategic public and private/public investments in infrastructure, energy, environment, TLC (NGN), R&D and human capital, and must promote and favour those projects which have strong positive externalities for the economy as a whole, and for human well-being and social cohesion. These projects need investments with long term differed returns, which only a few financial institutions, technically strong, "market conform", but ethically driven, are ready to support.

The Financial Institutions which may be "eligible" to be considered as Long Term Investors are, first of all, the institutions owned by public, semi-public or non-profit entities (States, Local Authorities, Banking Foundations, and the like): they do not seek speculative IRR or strong capital gains (also thank to the structure of their balance sheets which enable them to retain assets in their portfolios in times of crisis thus playing a counter-cyclical role in the financial markets); they are able to spread risks between generations; and finally have, generally, a clear social responsibility in their missions. This allows them to "accept" non speculative returns on their investments, as well as the willingness and the capacity to keep in their books long term assets and liabilities. Other institutional financial investors, such as large pension funds, insurance companies, Italian Banking Foundations, non-profit institutions, development banks and SWFs, may also be considered Long Term Investors if they decide to allocate some or most of their assets in that same type of investments.

The emergence of a strong group of long term investors may be the best ally of world policy makers in correcting the unbalances due to the crisis, restoring economic stability and value creation for future generations, counterbalancing short-term behaviours and financing recovery policies. This issue is especially important for Europe. If Europe wants to be a winner in the new "global competitive order" it needs to position itself, always, in the "highest part of value chain of products". In order to achieve such an objective, it needs a strong policy of investments with long term horizons. Only with such a vision in mind Europe may aim to become the most advanced Community in the world in terms of civilization, which includes infrastructures, culture, science, education, social welfare and environment.

For strengthening the contribution of Long Term Investors a new regulatory framework is needed, including ad hoc systems of incentives, in the accounting standards, prudential principles, taxation systems and corporate governance, as proposed by the de Larosière Group Report on Financial Regulation and Supervision and recently suggested also by Angela Merkel and Nicholas Sarkozy in a joint editorial. From a general policy point of view, we may even think of introducing special fiscal incentives for financial products and for firms which invest in the long term initiatives of general national or European public interest, on the lines of the fiscal incentives granted to the US Project

Bonds recently launched by the American Administration Stimulus Plan, as we shall discuss later.

The Problem of Short Termism and Its Role in the Crisis

The short-termism that characterized recently global capitalism has had very negative effects on the economy and on the financial global system and it is partly responsible for the present crisis. Its origin maybe traced back to a few well known factors.

Firstly, to the corporate governance model of the so-called "shareholders' capitalism". Such a model places the maximization value of the shares at the centre of the stage, even before the industrial or social value of the firm. The model of the firm is conceived as a mere "nexus of contracts". The management is contractually linked only to the shareholders and not to the workers, or to the stakeholders or, more generally, to the industrial future of the firm. The firm becomes then an abstract concept, and not a "community" or an "organism", as it was conceived in other past traditions, notably, in Continental Europe or in Japan and Korea. The managers of the firm are "winners" if they maximize the value of the shares, which is directly related to generous bonuses and stock options. This mechanism has created strong incentives to maximize short term, rather than long term, value.

Secondly, short-termism is related to the great liquidity and the low cost of money which has characterized the global financial markets in the recent past. The excess of unregulated liquidity originated in the 1970s with the birth of the petrodollar. Since then it has given a great contribution to the diffused and strong growth experienced in the global economy in the last decade. More recently, coupled with deregulation of financial markets and institutions, it has exacerbated arbitrage and short term speculation.

Thirdly: before market deregulation, the Western financial system was based on the strict institutional partition between "banking" and "securities". Socio-economic evolution and technological innovation have favoured the legal breaking up of market segmentation and the creation of financial conglomerates and giant financial institutions. The rationale of segmentation was based on the sound concept that risks are structurally different, requiring thus different institutions and different know-how. Banks manage credit and interest bearing instruments, securities' firms deal mostly with market risk. Deregulation brought typical "banking risks" into "objectified capital markets". Then, with the creation and the exceptional growth of the CDSs (Credit Default Securities) markets, it multiplied individual banking risks, creating the disastrous situation which we are in now. An excess of "temporal arbitration" (short versus long) and the end of specialization (the substitution of market-oriented over bank-oriented systems) are then both part of the problems which emerged with the recent financial meltdown (and meanwhile part of the solutions).

The New Long Term and Low Risk Profile of Investors

Given the rapid changes our societies are undergoing, the need for long-sightedness is now more urgent than ever. For example, for the first time, more than half of the world's population lives in cities. At the same time, the alarming pace of climate change requires massive spending to move to a low carbon energy economy.

The implementation of long-term global objectives, such as infrastructure building and fighting climate change is a necessity, as well as an opportunity. Shifting to a low-carbon economy, coping with the scarcity of natural resources or adapting to demographic growth and rapid urbanisation, will require major investments in the fields of innovation, renewable energies, water networks, urban telecommunication and transport infrastructures. These are all sectors which can yield high investment returns, stimulate follow-on investment and, as a result, create growth and jobs.

In the meanwhile, the crisis is changing the risk profile of investors. We will probably have a growing demand for long term and low risk investments products from large pension funds, insurance companies, SWFs and, in general, households. On the other hand we will have – as above remarked - a growing demand for infrastructures. The match between demand for long term and low risk investments and financing of long term strategic infrastructures, with stable cash flows and institutional endorsement, maybe a very sound and promising way out from the crisis. It will support the huge demand for financing infrastructures and it will probably give a contribution to the global financial markets' long term stabilization.

As for the European Union, the costs of the needed investments in infrastructures are huge. We have estimated that, only for achieving the 2020 objectives of the EU in Energy, Climate Change and Transports, the investments required can be estimated in the order of 2,5-3 trillion euros.

Therefore, one effective way for the European Union to face the crisis is to introduce new financial instruments not representing a burden on national public finances and on future generations. That maybe partially achieved by putting together European institutional long term investors to support large public/private initiatives.

The significant need for equity investment in the energy, climate change and infrastructure sectors, and the parallel need to provide debt, also by the support of guarantee schemes, is therefore the principal reason for some of the new initiatives undertaken by the European Long Term Financial Institutions involved – as core founders - in the creation of the Club of Long Term Investors and in the Equity Fund Marguerite.

The "Marguerite Network"

I will refer to the “Marguerite Network” as to that Group of European Long Term Institutions which gathered together, under the guidance of the European Commission and of the EIB, with the task of proposing further coordinated action with a focus on new financing instruments for Energy and Infrastructure projects. As you know, the initiative was launched after the Nice informal ECOFIN Council held in September 2008 and was approved by the European Council of December 2008.

The institutions involved in the first phase (together with the European Commission and the EIB) were Caisse des Dépots et Consignations (CDC), Cassa Depositi e Prestiti (CDP) and Kreditanstalt für Wiederaufbau (KfW). Others have recently announced that are ready to join the initiative.

Its first result is the proposal for an Equity Fund – called Marguerite – to invest in Energy, Climate Change and Infrastructure. The Fund – which will be presented in the afternoon session - will be “market oriented” but it will be characterized by three main feature which would make it a quite "unique" instrument in the European financial landscape of Private Equity Funds: (1) it will seek "non speculative returns"; (2) it will have Long Term horizon in its investments; and (3) it will have an institutional endorsement by the European Commission.

A similar initiative in the area of the Union for the Mediterranean has been taken with the creation of the Equity Fund InfraMed, by a joint initiative of CDC and CDP - which will also be presented in the afternoon section of our Conference.

The importance of the Marguerite Fund maybe seen as being the first "product" of this new "laboratory". If successful, it may become the first of a "Family of Sectorial Equity Funds" to support the "market" in financing the ambitious objectives of the Lisbon Agenda.

The Marguerite Working Group, however, has also been an occasion to explore other possible financial instruments and potential common initiatives. Among these I would like to briefly mention the so-called Project Bonds.

European Project Bonds

It has been recently observed, that financing infrastructure directly from the financial market by issuing bonds may be a more cost efficient alternative to debt financing. Transport and energy project bonds may be an interesting long term investment opportunity for institutional investors such as pension funds, insurance companies, SWFs, and households.

Individual project bonds may then be a sound and immediately implementable new form of financing of PFI Projects, in times where debt, equity and leverage are severely constrained, especially after the collapse of the monoline insurers and the subsequent closure of the wrapped bond market in late 2007, which meant that bank debt became the only viable source of debt funding to PFI projects.

The Project Bonds may also be promoted by the "Marguerite" network itself, by similar institutions, and by single projects, alongside the market. The "reputation premium", which may come from the EU endorsement and by the "high standing" of the long term institutions involved, as project promoters, may decrease the cost of financing, increase the credit ratings, creating an asset class which may attract large institutional investors (by matching their own liabilities – long term, fixed income) and, more generally, medium size European (retail) households' savings. Moreover, thank to well prepared projects, financing could be contracted directly from the financial market, without a need to appear in the Governments accounts. [1]

US Project Bonds

Also in the US, like in the European Union, the new Administration is attempting to combat a recession with an economic stimulus that includes a significant amount of investment in public infrastructures. The stimulus Plan provides the emission of new types of Project Bonds, with quite attractive fiscal incentives, directly on the net interest rate matured.

For example, "Recovery Zone Economic Development Bonds" must be used for public infrastructure projects or the construction of public facilities projects, job training/educational programs, and so on. The "Qualified Energy Conservation Bonds" devote an additional $2.4 billion to projects related to the development of alternative fuels, like cellulosic ethanol and to retrofitting buildings to make them more energy efficient. The new stimulus package has also devoted funding, by way of special project bonds, to the development of the US railway system, and has created $1.6 billion "New Clean Renewable Energy Bonds" to finance electricity generating projects using renewable sources, such as biomass and hydropower.

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1 According to ESA-95 Accounting Principles, the emission of financial instruments for PFI of a Government owned "market unit" is not included in the consolidated public debt (valid for the parameters of the Maastrcht Treaty and the Stability and Growth Pact) if at least two of the three typical risks of a PFI project (construction, traffic and tariffs) are transferred to the market. More generally, it is important that a financial intermediary does not simply act as an agent for other institutional units but places itself at risk by incurring liabilities on its own account. In this context, if a public financial unit does not place itself at risk by incurring liabilities on its own account, it will not be considered a financial intermediary and the unit is to be classified in the general government sector, rather than in the financial corporations sector, and its liabilities will included in the government's accounts.

Conclusions

To conclude. There is a need to support large scale and long term investments in the European Union to meet the ambitious objectives of the Lisbon Agenda and, at the same time, to give a contribution to the common effort to overcome the global economic and financial crisis and to create value for future generations. The "Marguerite Network" seems to have great potentials. In the future, it could become a new European institutional player. There are, indeed, very important opportunities to create common - "market conform" – long term financial instruments, which may give a substantial support to financing needs of European public investments.

The Club of Long Term Investors may become a very important tool to promote such initiatives and to exchange experiences and best practices, among investors who share a common vision that long term investment is an efficient tool to create value for future generations and foster economic stability. The scope of the Club is global and we encourage strongly wide international cooperation which transcends our national or European borders. We all live in the same planet and there is not exit from it. Therefore, the problems we are facing are global and they need global solutions. That is why we are well aware of the importance of having a real global scope in our initiatives. Institutions from North and South America, North and South Africa, the Middle East, Russia and Asia are all invited to join our efforts, to share experiences, and to work together for the same aim.

Finally, I hope that our initiatives and our vision may be received in the next G8 Summit in L'Aquila (Italy) in July and in the G-20 Summit in Pittsburgh (USA) in September, which is going to focus on long term sustainable growth.