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Towards a true European Investment Fund

A concrete proposal to operationalize the new Commission's € 300 bn investment package

Executive Summary

The threat of a deflation spiral in Europe is calling for immediate action to support demand and boost public/private investment. While the announcement made in July 2014 by Jean-Claude Juncker, the new Commission President, to inject € 300 bn in the European economy has raised expectations, few concrete proposals have been made so far on how to mobilize these funds. Against this pressing background, this note suggests the creation of a true European Investment Fund, in order to operationally flesh out the future Commission's investment plan, while reconciling the contrasting risk appetites of Member States. Its originality rests on the mobilisation of multiple resources and of various financial techniques. These features, when combined, increase the fund's firepower while allowing flexibility in its use.

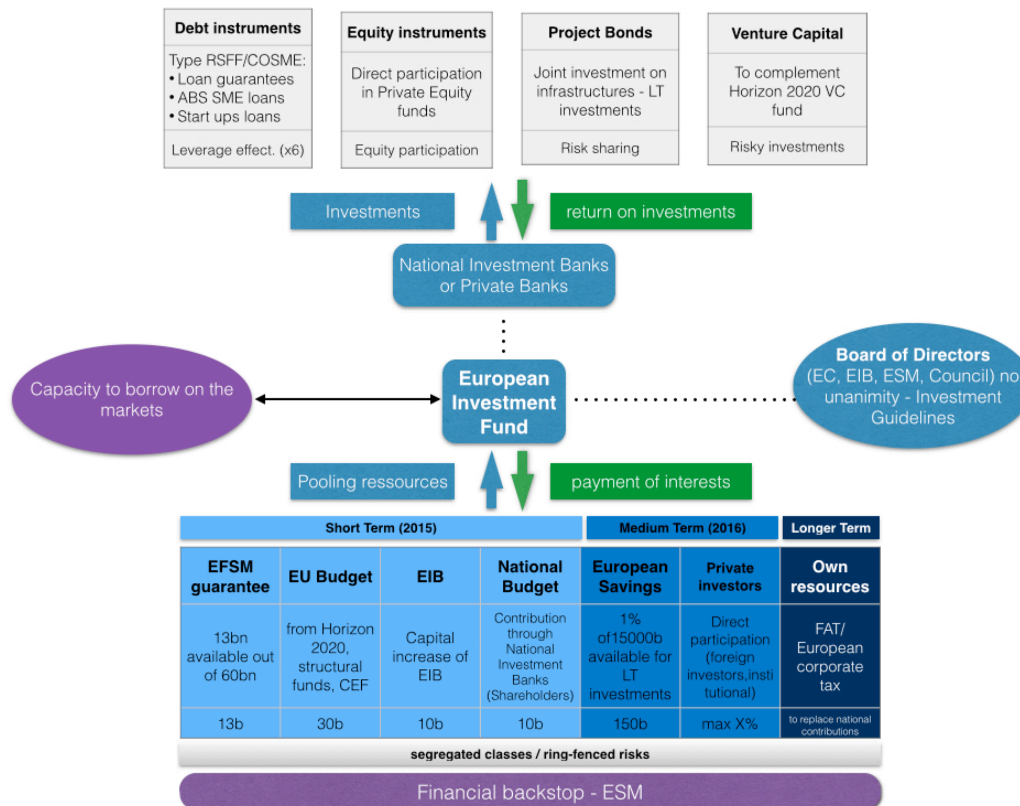

Figure 1: scheme of how the EIF could operate.

The memo argues in particular, through concrete quantified examples, that a true European Investment Fund could be used as a pivotal capacity to:

- Pool currently fragmented resources, both private (from individuals through a European Savings Book, from private investors through direct participation) and public (national and EU budgets, European Investment Bank, European Stability Mechanism);
- Develop a multi-instrument European investment strategy (through debt instruments, equity investments, venture capital, project bonds and other forms of project financing).

This investment capacity should not be seen as an exclusive tool to boost demand in Europe. It should not only respect the EU fiscal surveillance rules, but also be complementary to other structural measures that are needed both at European and national levels (especially in the areas of trade, competition, social/labor and tax laws) in order to achieve a more complete internal market and restore confidence into Europe's capacity to once again be a growth engine.

Issue at stake

A deflation spiral is around the corner in Europe. With persistently low inflation rates, slowing growth potential, high unemployment, and a continued reduction of credit to the real economy in spite of the ECB's record low interest rates, Europe's economic prospects are becoming alarmingly grim. The poor initial demand for the latest ECB offer of cheap refinancing conditions to banks (the so-called TLTRO) has raised questions on the effectiveness of the last round of the central bank's unconventional measures in restoring growth in Europe. Moreover, the ability of the ECB purchases of covered bonds and Asset-Backed Securities (ABS) to lift credit to firms, notably SMEs, is also uncertain. This is a serious cause for concern.

The perspective of a liquidity trap is no good news for the continent. Lower inflation, and *a fortiori* deflation, increase the value of the real debt stock (thereby partly offsetting deleveraging in the public and private sectors). At worse, it makes monetary policy unoperational. While there has been a lot of emphasis recently on the urgency of improving economic and financial structures to raise growth prospects in the medium term, thereby providing an incentive for business investment in the short term, such measures cannot be perfect substitutes for shorter-term stabilisation instruments, particularly given the procyclical fall of public investment during the crisis. In this context, the current constraints, both economic and legal, on the ECB's monetary policy have led to calls for revising the current fiscal stance in Europe.

After the large stimulus packages of 2008-2009, EU governments have been prone to do as little as possible on the demand side, leaving up the dirty task of 'saving the euro' to the ECB. As the ball is coming back their way, EU leaders should now invent unconventional and operational instruments to sustain demand in Europe by

supporting both public and private investment. It is therefore high time that the issue of investment is put on the European agenda. Investment has indeed fallen by 17% in the Eurozone since 2007 and the investment gap since 2008 is twice bigger in Europe than in the US or Japan. Even in Germany, the cumulated investment lag is estimated to be 3% of GDP between 1999 and 2012[1]. Several key decision makers have called for such an investment effort in Europe. Mario Draghi has for instance sent strong signals in this direction in his speech in Jackson Hole where he urged a "large public investment programme". The IMF has also explicitly alerted against the risk of not investing in Europe, not to mention the recent proposal by, Mr Szczurek, the Polish Minister of Finance for a € 700 bn European investment plan[2].

Despite these hard facts and real concerns, a difficult debate has opened between France, Italy and the southern Europe on one hand, and Germany, Netherlands and the Nordic countries on the other. The *Southerners* argue that reviving demand requires reducing the fiscal drag and that an investment plan, notably in network infrastructures (transport, telecoms, energy), would simultaneously allow to support the growth potential by increasing productivity. For them, without growth, it is impossible to pursue fiscal consolidation on the agreed path. The *Northerners*, although not totally opposed to the idea of boosting investments, have expressed strong reservations about an investment revival, arguing that investment strategies should not come at the expense of fiscal consolidation and can only succeed to the extent that structural reforms allow to raise growth potential and therefore the appetite to invest. The second group fears that the true reason behind the new investment debate spurred by Southern countries lies with their intention to escape from their fiscal discipline commitment.

Any political consensus will need to reconcile both sides. But this issue is not just a question of South against North. The split is actually more profound and has to do with the economic cultures of Member States. The political dimension of the issue – an opposition between the Keynesian Social democrats and the more orthodox Conservatives – should not be underestimated, even if the political realities are often more complex. It is interesting indeed to note that in Germany, in the light of the recent lower economic outcomes, some domestic actors have started to call for an investment plan to be launched (e.g. the *Bundesverband der Deutschen Industrie*).

As of now, all eyes are put on the announcement recently made by Commission President-elect Jean Claude Juncker, to propose an investment package of € 300

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[1] See the paper "For the recovery of investment in Europe", by Olivier Marty, European Issue n° 325 from the Fondation Robert Schuman.

[2] http://www.bruegel.org/nc/blog/detail/article/1426-keynote-address-from-mateusz-szczurek-minister-of-finance-of-poland/

bn (a sort of new Marshall plan) by Christmas 2014. Against this background, the European Commission and the European Investment Bank have taken the initiative of creating a taskforce with representatives from all EU Member States[3] to "identify potentially viable investment projects to be realised in the short and medium term" and "lay the foundation for a credible and transparent pipeline of projects".

While this initiative should allow to create a solvent demand for investment funds, the debate is likely to be more difficult on the exact funding resources of such a €300 bn investment plan, which are not part of the above taskforce's mandate. Where to find fresh money? How can the North-South divide be bridged? And how can an optimal pooling of public and private sources be ensured?

Engaging with these challenges, this note proposes the creation of a true European Investment Fund, backed by multiple resources and relying on financial techniques to reconcile the varying positions of Member States on this issue.

Possible designs of a European Investment Fund

As such, a European Investment Fund already exists. It is a fund attached to the EIB, whose shareholders are the EIB, the European Commission and a wide range of public and private banks. In its current design, the EIF is "specialised in providing risk finance to benefit small and medium-sized enterprises (SME) across Europe" through various instruments: equity (mezzanine funds), debt or microfinance. Its authorised capital is however limited to €4.5 bn. Therefore, in terms of financial capacity, scope and objectives, the current setting of the EIF is falling short of what is needed to re-launch investment in Europe.

A change of scale is necessary. Two options are possible: a modification of the mandate and scope of the existing EIF (attached to the EIB) or the creation of a new fund attached for instance to the ESM or to another structure. The choice between the two depends on the readiness of the Member States to agree on the investment question at 28, or alternatively in Eurozone or Eurozone+ format (i.e. with non-Eurozone Member States on a voluntary basis). Ideally, the fund would need to be feasible in Eurozone+ format (to avoid the political hurdle of unanimity) while preserving a link with the EIB, in order to be as inclusive as possible.

To reach the €300 bn, a multi-source approach needs to be envisaged. Indeed, given the fiscal position of the Member States, it is not possible to finance the €300 bn via Member States alone as it would mean increasing the debt of the Member States, although they should aim at reallocating funds towards investment within the current budgetary plans. This note hence promotes the creation of a fund to

[3] ECOFIN Council conclusions on measures in support of investment in Europe, 14 October 2014, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/145105.pdf.

pool different resources while avoiding the creation of cross or joint liabilities between the sources of financing (the risk will be ring-fenced), thanks to the technique of the segregated class of assets. In addition, and if needed, each class (and therefore each resource) could be attached to a specific type of investment, depending on the agreed political priorities. The fund could also benefit from a stronger leverage through the participation of the private sector (in particular institutional investors) and the capacity to borrow on the market.

On the resource side, several options could be envisaged which are neither exhaustive nor mutually exclusive: a mobilisation of European savings, a (limited) amount from the EU budget, a direct participation of the National Investment Banks, a direct participation of the EIB financed through a capital increase, direct investment by private shareholders including possibly direct foreign participation, and on the longer term, own resources.

These resources would be leveraged. Already with the current EIB capital, there is scope for additional lending and more risk-taking. At the moment the EIB is not using its full lending capacity (€494 bn are utilised, out of a capacity of €680 bn[4]) and has a rather conservative leverage ratio of roughly 1:9. The reason invoked for the relatively low risk-taking of the EIB is the preservation of its AAA rating. This is also the reason for not using fully its lending capacity, as the EIB argues that it does not have enough projects to finance with a sufficiently low risk profile. However, the *raison d'être* of the EIB is to correct market failures, not to avoid taking risks. Therefore, while the recently created taskforce should allow the conception of a pipeline of projects that match the EIB criteria, there is a strong rationale for the EIB to take more risk, even at the potential detriment of funding volumes. It is preferable that EIB financing is geared towards those projects whose take-off would not have otherwise been possible (for instance as a result of excessively tough financing conditions in Member States where interest rates remain high as a result of financial fragmentation) than towards projects that could have been anyway sustained on market terms (i.e. without support). To facilitate this task of credit-enhancement, the EIB can be supported by other European institutions. The ESM is already investing in EIB bonds, the EIB can refinance itself with the ECB and it could be envisaged that the ECB purchases EIB bonds on the secondary market[5]. The same holds true for the new European Investment Fund.

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[4] http://ec.europa.eu/economy_finance/eu_borrower/documents/eu_investor_presentation_en.pdf

[5] The ECB cannot purchase EIB bonds on the primary market as this would be in breach of the monetary financing prohibition (Article 123 of the Treaty on the Functioning of the European Union).

ESM or not ESM?

Before entering into details on the additional resources that may be considered, it is appropriate to discuss the possibility of a direct capital contribution from the ESM, as this item has been at the centre of a debate between (mainly) France and Germany. The ESM's primary objective is to serve as a backstop to ensure financial stability and solidarity through loans provided to programme countries (ie countries which have not anymore access to the markets to refinance themselves). There is currently €80 bn paid-in capital available at the ESM serving as guarantees to raise money on the markets and provide the required loans. According to some Member States, such capital is however not available because it is needed to ensure the stability of the euro area. For others, a share of this capital could be tapped as a resource for an investment plan, using it also to guarantee a financial capacity to borrow on the market.

On the legal side, some believe that such a move would require a change of the mandate of the ESM (triggering an obligation to change the treaty establishing the ESM through a cumbersome ratification procedure). However, reading the mandate of the ESM, whose aim it is to ensure financial stability of the euro area, it could also be argued that the investment gap in the euro area is putting its financial stability at risk due to the creation of a dangerous deflationary spiral.

On the political side, and on top of the opposition of Germany to such an extension of the ESM mandate, the non-participation of the non-Eurozone countries to the ESM – especially Poland – could make the use of this instrument more difficult. The investment gap is clearly an EU issue, and not only a Eurozone issue and therefore, such a plan should ideally be worked out at least in a Euro+ framework. To anticipate discussions on expected asymmetries between contributions versus benefits (as during the EU budget negotiations, typically), a construction in classes could guarantee a strict separation of resources and ensure for example that ESM money is only allocated to support investment in the Eurozone.

Besides investing part of the ESM paid-in capital in the EIF, the ESM could also or alternatively play another – and maybe more important – role in serving as a financial backstop for the Fund, allowing to limit its risk exposure (especially in the framework of the European savings instrument) and to ensure a good credit rating for the Fund (ensuring it can borrow on the markets at low cost). Alternatively, it could be envisaged to look more into the capacities that could be provided by borrowing on the basis of the EU budget. The reference example is here the EFSM, a €60 bn financial assistance facility (€46.8 bn of which are utilised), which has been set up in the middle of the debt crisis and which is guaranteed by the EU budget.

Other resources

In addition to the role of the ESM, it is in order to explain in more details the various resources identified in this note.

First, this note proposes to create a European Savings account to capture idle capital and use it to invest on longer term projects. It is considered that €15,000 bn are currently held as savings in the EU. If only 1% of these savings were re-oriented towards investment, it would secure a large share of investment needs. The design of such an EU savings account is however crucial for its success. It needs a credible and European deposit protection (or financial backstop) such as the ESM in order to delink the account from the banks offering them. Each European will be able to own only one of such account (in addition to potential national savings account they may have). A cap on the maximum amount deposited will need to be determined in function of the amount expected. Such an account will need to benefit from an attractive withdrawal and depositing scheme (frequency, easy access). The rate of remuneration for depositor should also provide sufficient incentives while the remuneration of the commercial banks offering the account should allow them to cover the costs they entail but not to realise major profits. This point is crucial and might be the real challenge and limiting factor in a period of low interest rates. It might be also necessary to set tax incentives. The collection of these savings could be done either directly by the EIF (centralised model) or through the network of public investment banks or other relevant national instruments[6] (decentralised model).

However, such an instrument is likely to raise strong political and technical concerns because of different approaches on the role of savings in the financing of Member States economies. It will also need to be built in a way that does not raise competition concerns. In any case, to mobilise European savings, a political compromise will need to be found, therefore, such a resource will certainly not be available on the very short term. At the same time, can we really afford not to orient such capital towards growth enhancing projects even if it is on the medium term? Is there any valid reason why one couldn't imagine using an enhanced cooperation to overcome political hurdles and start with willing Member states?

Second, the European Investment Fund could be resourced also by some (re)allocation from the EU Budget. There are already instruments attached to the current format of the EIF (COSME for SMEs, the Risk Sharing Finance Facility from Horizon 2020, the Microfinance facility from the ESF, the student loan guarantee facility from Erasmus+). All these instruments, despite having varying target groups, work the same way. The EU budget, often complemented with money from

[6] Not all Member States have a national investment bank.

EIB, is used as a guarantee for loans with preferential conditions delivered directly through banks selected by the EIB/EIF. To fund the RSFF, as an example, the EU budget and the EIB commit each €1 bn. And from the pooled €2 bn, it is possible to leverage approximately €10 bn of loans. Each additional €1 bn would generate €6 bn of direct investment capacity. Another example is COSME, the programme to support access to financing for SMEs. For the period 2014-2020, out of the €2.3bn of the programme, €1.3bn will be used through the current EIF, to finance guarantees, counter guarantees (securitisation for instance) and equity instruments. Concretely, it is announced that the €1.3bn would allow guaranteeing €21bn of loans for SMEs and €4bn in equity investments[7]. Here again the leverage effect is important and key to involve the participation of institutional private investors such as banks (and other financial intermediaries). In addition, this investment has a catalytic effect (typically x3) on other instruments. There is thus no need to reinvent new instruments. One should rather focus on enhancing the allocation of the existing ones. However, it might be difficult to open the discussion on the budget allocation given the limited room of manoeuvre and the current "deficit" situation of the EU budget between payments and commitments. Some could also argue that such reallocation is not "fresh" money since they were already planned. But what bring fresh money, would be to reorient direct grants from the EU budget (ie unspent money from CAP for instance) to leveraged instrument such as COSME. The "fresh" money part is in the leveraged money through the participation of institutional private investors (Banks).

Third it could also be envisaged that the national investment banks (or other relevant national instruments) enter into the capital of the EIF (it is already the case for some) and become shareholders. This would have the benefit to place the EIF directly into a network of national and powerful intermediaries, with a better understanding of local needs and risks. For Member states with no national investment banks, a direct contribution to the Fund should be possible. The EIB could also directly contribute to the EIF (as it is the case now), with any additional participation being financed through a capital increase of the EIB (such a capital increase has been proposed by Germany for instance). In any case, whether it is through the EIB, and/or through national investment Banks or direct contributions, national money invested in this Fund should not be counted into the deficit of the Member states (also since these are not recurrent expenditures), as an incentive to contribute. This could be part of a revised “investment clause” within the Stability and Growth Pact.

Fourth, it should be also possible for private investors (including foreign private investors) to participate in the fund. Indeed, President Elect Juncker himself

[7] http://europa.eu/rapid/press-release_IP-14-851_en.htm

announced his ambition to attract private investment, and this is also something that is more appealing for Germany. The structure of the Fund allows to conciliate attractiveness for private investors (who could see in the EIF a rather safe investment with strong Return on Investment) and political sensitivities (by making sure to limit the scope of investments in non sensitive areas)

Finally, over the longer term, the Fund could be financed through own resources such as a financial activity tax (FAT) or a part of a small European Corporate Tax (ECT).

In terms of objectives and domain of investment, it could be envisaged that projects are selected in line with current political priorities, such as Infrastructures in Energy, Telecoms (including Internet), Green economy, Transport, Research, Innovation and Education. The taskforce created at the initiative of the Commission and EIB could be institutionalised and meet regularly in the context of the new European Investment Fund, with a view to maintain a permanent pipeline of viable projects and find solutions for the obstacles they face.

Once decided the financing structure of the Fund, it would operate through a board of directors in charge of deciding the investment strategy of the Fund. The European Commission, the National Investment banks, the EIB, and the Member States should be represented in this board. The new EIF would have several instruments at disposal to support investments in different sectors with different objectives, consistent with those that already exist:

- **Debt instruments**: On the model of the existing type of instruments based on a leverage effect, these instruments would be implemented through the existing network of financial intermediaries in Member States. The targets could remain SMEs – extended to bigger companies - but to a larger scale. SMEs being the backbone of our economy, the impact could be important, especially since their access to finance is currently reduced. This instrument would allow reinitiating the growth engine while being complementary of ECB actions.

  In particular, it could be used to counter guarantee high quality SME loan securitization (ie ABS instrument backed by loans to SMEs). The new COSME programme allows it, but it should be strengthened and highly marketed as this would complement efficiently the upcoming ECB programme of ABS purchase[8] due to start in November as well as the new regulatory framework proposed by the Commission[9] on including high quality, tradable, transparent

[8] http://www.ecb.europa.eu/press/pr/date/2014/html/pr141002_1.en.html
[9] http://europa.eu/rapid/press-release_IP-14-1119_en.htm?locale=en

ABS instruments (notably for SMEs) as eligible assets for credit institutions' liquidity buffers. Securitisation allows banks to refinance loans by pooling them and converting them into securities that may be liquid, tradable and attractive on the financial markets. It also allows banks to regain some margin to lend to the real economy as these ABS instruments can be "taken out" from their balance sheets. Therefore, through a strengthening within COSME of this counter guarantee given to the banks for ABS instruments based on SMEs loans, this could have an important impact on the ability of banks to lend more to the real economy. However, one should learn the lessons from the past (and from the subprime crisis especially) and make sure that any such ABS instrument should be transparent (we are sure what is in it) and of quality (no junk products attached to better ones). Based on the proposal of the Commission in October, such a control should be assured.

- **Equity instruments**: even if already existing, they remain marginal and should be largely promoted through the new Fund. It is estimated that in Europe, only 1/3 of the real economy is financed through equity, against 2/3 in the US. The overreliance on debt and bank financing needs to be solved at European level. The new Fund should be allowed to invest directly in Private Equity Funds, and contributing therefore to attract private investment to such a financing channel. Indeed, equity is essential as an alternative source of financing for companies. However, stepping up this activity would require to develop additional expertise and certainly national and even regional networks/contact points.

- **Long term infrastructure investments through project bonds**: by definition, these investments are risky and less likely to be supported by normal means of financing (banks). It is therefore necessary to develop a capacity to finance such infrastructure projects for instance in energy or telecom infrastructure but also for the green economy. The Fund will have to be able to pool private and public resources finance through project bonds.

- **European Venture Capital Fund**: the European venture capital market is fragmented, but venture capital is crucial to finance innovation, entrepreneurs and start-ups in their initial and growing phase. The European Investment Fund will have to develop such a capacity.

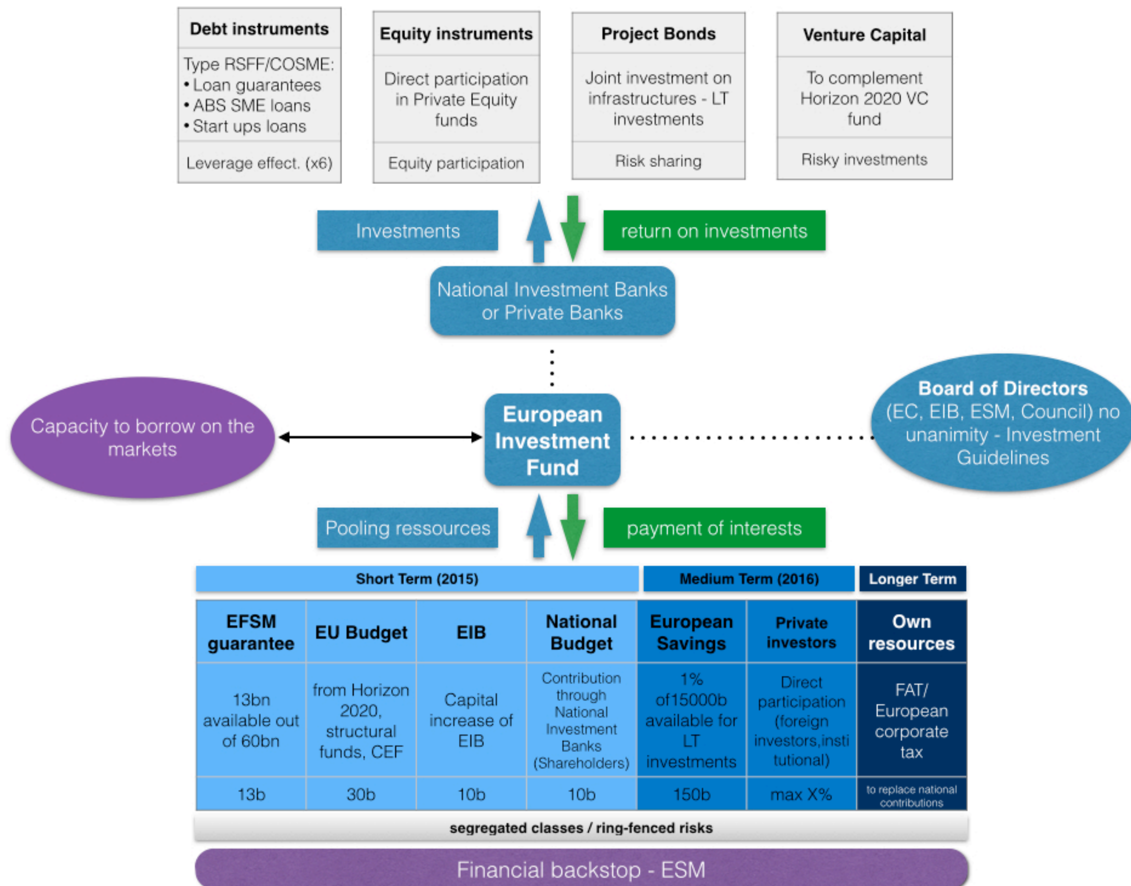

Figure 1: scheme of how the EIF could operate.

Conclusion:

Driven by the imperative need to avoid a deflationary spiral, political momentum is currently gathering pace in Europe in favor of the relaunch of investment. Further to Jean-Claude Juncker's announcement of a € 300 bn investment plan, the priority is now to identify ways of pooling existing and new resources in order to leverage a strong investment capacity. Finding ways to build an acceptable investment framework at European level can also be the basis of a political compromise between fiscal consolidation and growth strategies in Europe and be a way out from the current opposition on the fiscal position of France (and to a lesser extent Italy).

This could be done, as this memo has argued, through the creation of a true European Investment Fund, less risk adverse, better resourced and with a wider scope of actions and investment strategies.

As explained in this note, the use of a Fund presents several advantages:

- The pooling of resources creates a strong leverage effect either through the direct capacity to borrow on the markets at low interest rates or through the sharing of risk with commercial banks, mobilizing therefore the private investors (through institutional investors, i.e. banks).

- To avoid, thanks to segregated classes, cross/joint liabilities between the different resources. This is important to conciliate political oppositions and concerns. It allows also to attract private investors (individual through the European savings book or private investors directly). This is also one of the reasons why the ESM is legally built as a Fund. As such the new EIF will be the direct mirror of the ESM, the EIF being focused on investment while the ESM deals with financial stability.

- It helps to take into account the asymmetries between Member States in joining a European investment plan. If it is not possible to agree the plan at 28, it should be done at least within a Eurozone format and ideally in Eurozone+ format. The flexible structure of a Fund allows taking this issue into account.

- It answers to the dynamic of the investment plan: not all resources will be available on the short term and at the same time. The Fund could be resourced progressively and the share of these resources in the financing of the Fund could evolve in times:

    - On an immediate basis through a stronger EIB participation, National Investment Bank taking shares (so direct national participation), a limited reallocation of EU budget and on a transitional and phasing in basis, capital from the EFSM. This could account for the first €100bn for 2015.

    - Then, the Fund could mobilise European savings book as well as Private (institutional) investors

    - On the longer term, own resources could be envisaged thereby allowing a progressive decrease of national contributions to the Fund.

Such a Fund could also be the embryo of a more ambitious and long term instrument: a genuine fiscal capacity, especially for the Eurozone, fed by own resources and a capacity to borrow on the market.

This proposal certainly requires additional technical work, especially on the exact financial engineering of the fund in order to answer even better the varying political expectations at hand. But its potential is important and should not be overlooked. This memo thus recommends that a comprehensive assessment of its feasibility be conducted over the next two months by the Commission, EIB and

Member States (for example as part of the Economic and Financial Committee) also involving National Promotional Banks.

Euro2030 - Who are we?

We are advisors to European leaders, advisors in national permanent representations to the European Union, parliamentary assistants, officials from European institutions, European affairs professionals in the private sector in Brussels. We are young, but with an accute experience of the internal functioning of the European Union. As 'Eurocrats', European affairs are our field of expertise, but we do not lose sight of the political realities. We are all writing in our personal capacity and we do not commit our respective institutions or companies.

We are apolitical: we do not support any political party as a group (although some of our members are part of various political parties).

Our objective is to stir a much needed debate on Europe, to propose a vision and concrete steps forward, taking into account political realities and the existing setup. In short, we want an ambitious Europe. We want to wake up national political parties so that they take part in this debate. Europe is above all a political project and as such it must be at the heart of the democratic debate.