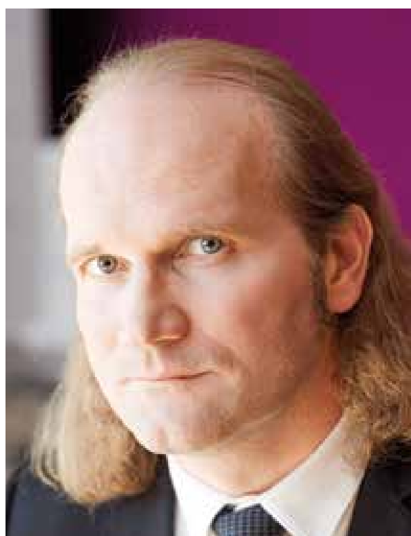
Tackling long-term investment disincentives



Harald Waiglein

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Long-term investment – how to proceed in a changing economic landscape

It is common sense in economics that investing is not an activity one should stay idle on for a long time. In the absence of a proper capital stock, technological progress is hindered and will pass by without creating positive spill-overs. Moreover, convergence and rebalancing in a monetary union are stalled when efforts to modernize economies and to pursue structural reforms are lowered. Unfortunately, public and private investment contracted in several EU Member States and the Euro Area as a whole during the crisis and still display low levels.

As a reaction, Ministers of Finance agreed on common principles to promote investments in 2017. Accordingly, efforts and reforms should focus on (i) facilitating efficient resource allocation, (ii) high quality public investments and (iii) market-based sources of financing. Furthermore, investments in general gained importance in EU economic governance. This year's country specific recommendations contain respective elements addressed to every single EU member state.

> *"A high level of human capital triggers investments in other intangibles and physical capital."*
>
> \- HARALD WAIGLEIN

In short, we are aware of the importance and developments of investments as well as how reforms goals should be set. However, what about the long-term perspective and the interplay between public and private investment? How should incentives be set?

It is clear that challenges such as climate change, digitalisation, ageing societies or migration need to be addressed right now to avoid staying behind the curve. It is also clear that private and public sector efforts need to be aligned to do the job. While a business environment without bottlenecks and unjustified regulatory barriers is a prerequisite for successful private engagement, high quality and sustainability of public finances are decisive as well. Whenever public funds are overly spent on debt service, outdated technologies or inefficient structures, they do not create much value added.

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>>> Projects and priorities have to be carefully selected and stay within the available fiscal scope. Comparing current general government net debt levels and capital stocks reveals that many Euro Area members still incur debt for other purposes than investment.

Spending Reviews can help in this context in two major ways. Firstly, a holistic application of these instruments on all budget items can help to create the required fiscal space for investment, even in an uncertain economic environment. Secondly, spending reviews can play a role in identifying opportunities for high quality public investment, ensuring that the allocation of funds is efficient and that investment multipliers are maximized.

Various economists point to education and skills as important factors to boost private investment. A high level of human capital triggers investments in other intangibles and physical capital. Other areas of eminent relevance at the current stage and carrying a potential "double dividend" are resource efficiency, green tech and R&D&I in general. This is exactly where especially economies at the technological frontier should go as they need to create new comparative advantages. Of course, all efforts need to be based on a sound structural basis as it is not wise to pour water into a leaking tank.

Taking a deeper look at incentives to invest, it is obvious to talk about costs and availability. Completing major projects such as the Capital Markets Union and keeping up EU-wide investment programs, but also clear-cut rules for alternative financing and currencies could support access to funds. On the other hand, internalising external costs would increase the payoff of investments in resource efficiency. Both aspects - policies focused on the demand and supply side - need to be part of our tool kit.

Summing up, it is essential at the current juncture to keep creating enabling environments and carefully selecting those areas for investment that are forward and not backward looking. This especially holds true for education and skills. However, in the end public efforts need to be backed up by a sustainable financial position. ●

Märten Ross

Deputy Secretary General for Financial Policy and External Relations, Ministry of Finance, Estonia

Regulation of risk taking by households and the problem of overprotection

Are existing regulations reinforcing the risk/long-term investment of households?

To start with, one could wonder if there is a basic issue of undersaving by households in the EU? Probably not, although differences persist. Therefore, prime question is rather about the structure of asset allocation that we seem not to be satisfied.

There is some reason to believe that one reason for this misallocation lies with regulatory approach. Partly and paradoxically, some part of the problem lies in that existing regulatory environment tries to overprotect retail investor from the risk. Maybe to the extent they themselves do not even desire.

This includes unnecessary liquidity requirements and risk coverage requirements for equity investments. Commensurate cost of regulation is at the end excessive and thereby tends to limit such risk taking unnecessarily.

Furthermore, it is not just savings' supply side that is problematic, but also the way how demand side functions. Large junks of economy continue to rely too much on financing structure that does not support active public participation in risk taking. If the supply side remains unwelcoming it constrains more risk taking by the households in the financial markets.

All in all, the situation in the single market remains uneven.

"Cost of regulation is at the end excessive and tends to limit risk taking unnecessarily."

\- MÄRTEN ROSS

What should be changed regarding consumer protection concerning long-term investment?

There is some mix-up in discussion between knowledgeable long-term >>>

>>> investments by households and their intentions to invest (preferably) into liquid assets that might include also long-term underlying instruments. The problems are mostly with the first one and regulatory work should support primarily incentives to allocate some savings into less liquid proportions of the market.

New technologies and other innovations of financial intermediation could help there and should be wisely treated. It is true that in many cases the innovations are merely a circumvention of the regulation and in that sense rather old-fashioned animals in substance.

However, in many cases the innovations are also a sign that readiness of public at large to engage into more aggressive risk taking is somewhat bigger than consumer protection paradigm admits.

How to transform savers' stable resources into long-term investment without imposing excessive constraints?

If the underlying problem is not saving rate as such, but the sub-optimal composition of the assets the savings are allocated, primarily into "low-efficiency" banking deposits, both push and pull factors need to be addressed.

Explicit or implicit regulatory cost advantages that support asset allocation into more liquid and so called safe assets, including state debt, could be constrained.

Finally, one should recall that it is not just strictly financial sector regulation that influences household asset allocation. Tax and other incentives to overinvest, eg into housing market, matter as much as a details of the financial market regulation. ●

Patrice Morot

Partner, PwC France

Prudential and accounting standards may trigger a further decline in the long-term investment in equities by insurers

It is often argued that insurers should finance the economy by buying long-term assets (like listed and private equities, infrastructure investments, and securitization). However, Solvency II and IFRS standards, which are based on mark-to-market values and a short-term risk horizon, may prevent insurers from playing this role more fully.

Three main obstacles stop insurers from investing with a long-term outlook.

The first one relates to the duration of their liabilities and asset-liability management. In France, most insurers liabilities come from life insurance products composed mainly of saving contracts of which 80% are participating and 20% are unit-linked. The average duration is 12 years, but policyholders have the right to surrender their contract at any time at carrying value, without any penalty except a loss of tax incentives. Because of low, if not negative, interest rates, even a 0% minimum guarantee on participating contracts could be "in the money" in the current economic environment. In the event of a financial crisis and a rise in interest rates, life insurers would be exposed to liquidity risks and financial losses, making them cautious regarding their long-term investment strategy. To enable insurers to invest more in long-term assets, we believe actions should be considered that would increase and provide better predictability of the duration of their liabilities.

The second factor relates to solvency rules. Under the Solvency II framework, assets are measured at fair value and stresses are calibrated in accordance with a VAR at 99.5% over one year. Thus, the shocks applied on equities are relatively high (39%-49%). One can easily see how a fair value measurement basis and one-year time horizon are not consistent with making longer-term investment decisions. Updates to the Delegated Acts published this year introduce a new class of Long-Term Equity Investment benefiting from a reduced shock at 22%. Even if this change would normally act as an incentive, the eight eligibility criteria of LTEI appear very restrictive, which could prevent a reversal of the current trend, despite the best intentions of the European Commission.

Last year, the French Treasury Department and the Dutch Ministry of Finance proposed more robust incentives in favor of equity investments to the European Commission. A study undertaken by PwC at the request of the "Institut des Actuaires" in France estimated that the proposed scheme might result in an increase to equity investments estimated to be worth between 50 and 100€ bn across Europe. In 2020, the Solvency 2 Directive will be revised, and this opportunity should be seized to review the criteria of LTEI and allow further investment in equities.

The third factor relates to IFRS accounting principles. The new IFRS9 standard, which will be effective at the same time as IFRS17 for the majority of insurers, ie January 1, 2022 is likely to increase volatility in the P&L:

- IFRS 9 will cause insurers to classify most of their equities at Fair Value through P&L (FVPL) since classifying equities in FV through OCI will not allow them to recycle the realized gains and losses through the P&L;
- the only measurement applicable to mutual funds will be FVPL, and insurers hold most of their equities through these types of funds.

IFRS17 will partially address this concern for assets that are used to back insurance contracts that are substantially investment-related and where the insurer promises an investment return based on the performance of these underlying assets (i.e. insurance contracts with direct participation features). However, for equity and mutual fund investments that are used to back all other types of insurance contracts or indeed the insurers' own funds, the IFRS9 measurement model remains an issue.

The resulting increase in volatility through the P&L will not be conducive to long-term investment by insurers.

These three factors combined with the low interest rate environment could lead insurers to carry on divesting from equities unless something is done to change the situation. It is urgent that actions are taken now to enable insurers to continue playing their important role in ensuring long-term sustainable growth across Europe. ●

Cyril Roux

Group Chief Financial Officer, Groupama

To finance the European economy, normalize its framework

European finance vexes multitudinous desires to drive its behavior. German public figures decry the nil return offered to German savers on risk free assets. French politicians wish to increase the equity allocation of insurers, public companies and asset managers in domestic ventures. Irish commentariat laments the mortgage rates required by domestic banks in a market which suffers from high delinquency and low repossession. In other countries private equity firms, merchant or high street banks, markets and "vulture" funds are variously condemned for failing to pursue the public interest. And in more rarefied settings one long-standing criticism leveled at these institutions is their insufficient provision of long-term capital to the financing of the European economy.

It has long been observed however that spot pricing (so called "market consistent valuations") drives European retail investors away from assets with volatile market prices. Americans seem more inured to the fluctuations of their 401(k) account statements. By importing the "fair value" IFRS standard into the accounting of heretofore patient institutional investors, Europe has made the fateful choice of driving them away as well from listed securities. The vaunted benefits of this choice, transparency and comparability, have failed to materialize, but the European economy suffers from the all too real economic disincentives at play. The upcoming application of IFRS 9 to European insurers will aggravate these disincentives unless the EU ceases to kowtow to the IFRS board and make good on its ambition to be a global rule maker rather than a rule taker.

The EU has decided to base its prudential regulation on IFRS accounting, and its ever-increasing reliance on volatile market prices. By so doing, the EU has built in procyclicality into the reaction functions of its banks and insurers. To reduce it, it has then added countercyclical buffers, volatility adjusters and dampeners. But these mitigating measures cannot undo the core procyclicality it has decided upon. When regulatory ratios decline and get closer to thresholds for regulatory intervention, the major adjustment lever available to European financial institutions is to divest; when financial markets decline, this feeds a vicious sell off circle. Current European financial regulation has been designed with the prevention of a 2008 replay in mind. It is yet to be tested, but it has certainly failed to take sufficient account of its effect on the financing of European economy.

The extraordinary interest rate environment under which European banks and insurers operate today combines with the aforementioned accounting and regulatory disincentives to further distort the allocation of capital and provision of credit. Here also, the merits of an unprecedented monetary policy are debatable whereas the costs and risks associated are building up. In such an environment, it is pointless to flog financial institutions into acting as if financial markets, accounting and regulation were otherwise. One would be better advised to normalize monetary policy and devise an appropriate accounting and regulatory framework for the European economy. ●

Markus Ferber

MEP, Committee on Economic and Monetary Affairs, European Parliament

Boosting long-term investments in the EU

Investments are the lifeblood of an economy since they pave the way for long-term success. Today's long-term investments lay the groundwork for tomorrow's economic growth and tomorrow's overall welfare. Therefore, it is more than worthwhile to pay close attention to how the European economy is faring when it comes to channelling capital into the right areas.

If we want to achieve our policy goals - such as making Europe fit for the digital age, transitioning towards a carbon-neutral economy and improving the EU's long-term competitiveness - we need investments in the trillions. With public purses being strained and government debt levels at all-time highs, it is clear that a very substantial part of the investments needed have to come from the private sector.

In general, there are two areas we have to look at. On the one side, we have to think how to unlock the considerable amounts of money held by institutional investors such as insurance companies. Insurers with their long-time horizons are the perfect long-term investors, e.g. for infrastructure or green transition projects. However, despite this helpful match in terms of characteristics, we see too little actual long-term investment by insurers. Part of the problem is that that the capital requirements laid out in Solvency II are sometimes too conservative, particularly when it comes to equity investments and long-term investments. With the review of Solvency II that is due this term, we have to tackle this issue.

The other side of the medal is making investments into capital markets

more attractive to private investors. This is even more relevant as traditional European pay-as-you-go pension systems are under increasing pressure and private retirement arrangements will become increasingly important. One element of this is certainly long-term since it is cultural. In Europe, we are lacking the same risk-taking >>>

>>> attitude as for example in the United States. This is why many Europeans prefer to put their savings into low-yielding savings accounts - despite the record low interest rate levels. However, such a cultural change will only be possible in the very long run and can probably only be achieved if financial education gets a much bigger role in our education system.

However, while those long-term improvements are certainly important, we also have to think hard about what can we do in the short term to make accessing capital markets more attractive. One part of the equation is to offer retail consumers attractive and easy-to-understand products that can be easily invested in. In this regard, the UCITS framework was certainly a successful example of how an attractive product category could look like. To make such investments attractive and overcome investors' fears, it is essential that retail clients understand what they are getting into, which makes information to clients a key issue. Unfortunately, today's disclosure regime with similar, but not identical requirements in UCITS, PRIIPs, MIFID II and IDD does not inspire the retail investor's confidence. A horizontal approach that aligns the requirements and also focusses on the key metrics an investor needs to understand before investing will therefore be a key project in the new term. ●

Alexander Batchvarov

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EU regulatory framework: enabler or barrier to securitisation in CMU?

The EU securitisation law came into force on 1 January 2019 without the full set of enabling regulations ready. This led to an initial delay and subsequent crowding of deal supply, which in turn led to pricing distortions. Some of the key RTSs (e.g. data templates) are unlikely to be implemented before year end, i.e. one year after the law came into force. The extra-territorial reach of the regulation impaired the global investment reach and returns of EU regulated investors. The inadequate grandfathering and limited transition period did not help either.

STS deal flow picked up in 2Q19 and the STS securitisation sector is gradually building up. Over time we believe STS will become an established market and, some suggest, a global benchmark. The non-STS sector will tag along, as has done so far successfully. STS was meant to address some borrowed-from-the-US reputational issues of the EU securitisation market, whose credit and rating performance since EU market's inception has been excellent, in line with initial expectations. However, STS alone is not enough to restore EU securitisation market.

To reach the full potential of securitisation to foster long-term investments in the EU financial sector a number of barriers need to be overcome. Some of the barriers are associated with the interpretation of the securitisation regulation, such as the lack of differentiation between public widely-distributed deals and private bi-lateral deals between sophisticated counterparties, several operational issues, extra-territoriality of investor due diligence, etc. Other barriers arise from biases embedded in the prudential regulations, related to capital charges, reporting, liquidity, etc., which in turn distort issuer and investor behaviour. The SRT discussion is already raising concerns.

Overall, a quick look at the capital charges for financial institutions suggests that insurers are dis-incentivised from taking securitisation longer-term mezzanine risk, which they are otherwise uniquely qualified to do. Insurers are incentivised to take illiquid loan and residential mortgages exposure directly rather than through securitisation bonds; the cliff between STS and non-STS capital charges cannot be justified, in our view. Banks are incentivised to buy each other's covered bonds, often collateralised by the same mortgage exposures they hold on their own balance sheets; this is further enhanced by the unjustified gap in LCR treatment of covered bonds and STS securitisation. In public debate the systemic risks created by covered bond and loan holdings are glossed over, while the risks of securitisation exposures are overstated. The unjustifiable gaps in cost of different funding instruments (rating, reporting, verification, penalties, enforcement, etc.) biases issuers' choice: banks prefer covered bonds, fincos - securitisation. ESN, if introduced, will distort banks' motivation further.

STS securitisation volume is picking up, but the recovery of the securitisation market is far from assured. In order to advance the CMU and foster a long-term positive economic effect of securitisation in the EU the above distortions must be addressed, the capital and liquidity cliffs eliminated or reduced, the capital markets' playing field levelled. ●

Lauri Saraste

Director, ALM & Solvency, LocalTapiola Life

Long-term insurance business model faces challenges today

Long-term perspective in the insurance business model has been highly important for insurers to both offer products that suit the customer needs but also to invest so that returns and customer benefits are created. The products insurers provides for citizens and corporates plays crucial part when it comes to risks they might need to face by their >>>

>>> own without these solutions. The same applies on savings and pension plans, as different guarantees and customer options towards the insurer or the ways of providing liquidity brings a long-term safe, customized and stable way to save for the future. By fact, the number of insurers ending into liquidation, remains to be really low in EU. By that, it has helped to ensure the functionality and stability for both the European insurance- and finance industry and the societies.

Mutual insurers, which are insurance undertakings collectively owned by its members who are at the same time its clients (policyholders), cannot make decisions based to short-term optimization. This is because the congruence of ownership and control and being same time customers of the very same undertaking. This makes it necessary to establish a balance between maximizing profits and delivering optimal high-quality services and benefits. By this, decisions can be based on stable and long-term measures, which are highly needed for providing stability for the financial sector and societies. AMICE, the Association of Mutual Insurers and Insurance Cooperatives in Europe, aims to ensure that this perspective is brought out in the best possible way.

The long-term business model, especially among mutual insurers, can survive if the European regulatory environment allows both long-term commitments towards the insurance customers, but also investment strategies that gives possibility for a broad diversification into different asset classes. And this can provide benefits for the societies and improve welfare in many ways, aging population and the increased need for savings for individuals to name a few. This is particularly stressed now, as even though we have good and holistic regulatory framework in place, there is reviews going on at the same time when the economies are facing different challenges. To best survive this, will call for a regulatory framework that rather enables than disables the different ways keeping the long-term perspective, and allows the use of market based stabilizing mechanisms and robust valuation principles. Similarly, insurers need to crystallize the measures behind the long-term perspective, which should more and more be centered on the customers.

Sustainability, and especially actions to slow down climate needs to be part of any long-term investment strategy and insurance offering. But this requires a common ground for understanding and defining the concept across Europe. We in LocalTapiola mutual Insurance group (Finland) have had ESG measures a part of our investment process a long time, and closely think where to invest, when to take actions as a shareholder and whether to exclude something. Yet the information available and the lack of real data makes the actions difficult. The increasing awareness of climate change is helpful but not making it easy to take fast, forward-looking and brave actions. As one solution, we in LocalTapiola, see that the possibility to diversify highly over different asset classes, on both public and private markets, creates a number of benefits in terms of influence, awareness, risk and returns and even on stewardship. Moreover, we see that offering the same investment opportunities for our customer owners via different saving possibilities, helps them to access the very same benefits. ●

Sébastien Raspiller

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Renewing the EU narrative toward long-term investments to strengthen our economy

Since 2015, the Capital Markets Union (CMU) have made progress towards a more resilient and consistent framework for financial services in Europe. However, despite having furthered the logics initiated in the aftermath of the financial crisis, the CMU remains a largely "theoretical" endeavor whose end-benefits were not clearly explained. Now, we need a renewed narrative, notably on the competitiveness and growth prospects of European economies, which require other financing capacities than bank financing, especially for long-term investments.

For the World Economic Forum, long-term investment can be defined as "investing with the expectation of holding an asset for an indefinite period of time by an investor with the capability to do so". Indeed, the main specificity of long-term investors is that they do not intend to capture short-term variations of value or immediate liquidity. They focus on economic fundamentals and are deeply involved in the management of their investments. Thus, they have a role to play as capital stabilizers and contracyclical forces which need to be acknowledged by public authorities. Moreover, as co-legislators, we need to lift the barriers to the financing of the economy, especially in equity which allows for more risk taking and innovation while bringing new products and diversification to investors.

However, the time horizon of our prudential and regulatory framework has been shortened over the last years. While enhancing the transparency of financial statements and the European harmonization of supervision, the focus on fair value and the calibration of prudential treatments have had negative effects on long-term investments: for instance, investments in infrastructure in Europe are 20% below pre-crisis level while we are net exporter of investments since 2015.

In particular, the Solvency 2 framework relies on the assumption that insurers should resist in the next year to shocks that statistically happen every two hundred years. This well depicts the situation of an insurer that would actually have to deal with those shocks on a short-term horizon, selling assets in stressed situation in order to cope with its liabilities. But it creates a strong disincentive for insurers to invest in equities, even when they can prove those equities would not be sold in such situations. This is all the more detrimental that insurers are, due to their specific business model, well suited for long-term investment. In parallel, EFRAG is currently assessing the impact of the new accounting standard IFRS 9 on long-term investments in equities. We will need to take stock of its conclusions.

Thus, we need to adapt our regulations to the fact that - as Jacques de Larosière expressed it - "the long-term is not more risky, but has a different risk profile". We owe it to the financing of our economies, notably for climate transition which will indeed require long-term thinking by investors to enable projects such as resilient infrastructure or the mainstreaming of renewables. Long-term investing is now a top priority of the Commission action plan for financing sustainable growth, notably with a focus on non-financial corporate disclosure, which will help investors make better informed decisions regarding the way they create long-term value. ●