DEVELOPING A STRONGER EUROPEAN INVESTMENT CAPACITY

The Chair asked if enough has been done to date on long-term investment and if the topic is still high on the agenda. The next Commission will have the challenge of restoring confidence. There is progress to be made on risk-sharing and reduction, as well as on capital markets union (CMU). It is wanted, but when the Commission's first proposal was presented to Eurofi there was no appetite for CMU without unified supervision. Europe must move ahead but there is a loophole in wanting a fully-fledged CMU with supervision by member state-driven institutions.

AML is an elephant in the room. Supervising capital markets cannot be discussed without considering AML. Everybody has in mind what will happen with Brexit and with other trading partners.

Long-term investment must consider Environmental, Social, and Governance (ESG) criteria and sustainable finance. The Commission has successfully married sustainability and finance, although more can be done. The first question is why the EU needs stronger long-term capacity and what it involves, before answering why long-term investment is particularly low in Europe and which sectors need to be strengthened.

1. Long-term investment remains low at a time when the challenges facing the EU demand a significant investment effort

1.1. The need for a stronger long-term investment capacity in Europe

An industry representative noted that investment is needed due to a large investment gap in Europe, particularly in sustainability and digital. The Commission estimates that the investment gap for a sustainable model is €180 billion per year, concentrated in energy and transport. The issue is how to accelerate these investments for the public and private sectors. The financial sector can shrink the investment gap by focussing on SMEs. Large companies have other options, but SMEs are dependent on banks. Buildings from an area for action, representing 40% of energy consumption and with 70% of the stock being energy inefficient. Promoting investment by advising SMEs is helpful, as is support via initiatives such as the energy efficient mortgage.

European digital lags behind other main countries, particularly the US on artificial intelligence, and the use of data for good as there is good data protection. Investment in super computers, artificial intelligence, cyber-security, the labour force's digital skills and wide use of digital technologies is essential.

A Central Bank official noted that benchmarking investment in Europe is key. Recent publications conclude that there is under-investment. The last decade's investment evolution for the euro-area and EU explains the devolution of investments. Non-construction investment was around 9% of GDP before the crisis and is around 11% for the Euro-area and 13% in the US. Public investment is low, as governments prioritise reductions against other social expenditure.

Long-term growth has followed a downward trend during the past 20 years, with euro-area figures of around 1.5%, well below those of around 2% in the US. This is driven by factors including low productivity, demographics and persistent weakness in business investment. Two factors represent important obstacles for investment activities. The first is economic policy uncertainty, at record highs in 2018. Global trade policy, Brexit and the lack of decisive steps to further increase European integration affect this result. The second is private and public indebtedness, which remains on average above pre-crisis levels.

1.2. What an EU stronger investment capacity would involve

The assessment that change is needed begs the question of who can create the necessary regulatory, supervisory and economic framework for more long-term investment. Can financial intermediaries use existing regulations like Solvency II, MiFID, IMD, Basel requirements, accounting standards, IFRS and existing product, UCITS, pension funds and PEPP to direct household saving to Europe's long-term investment needs and what is lacking in the economy, regulatory and supervisory framework for strengthening investment capacity.

1.2.1. Optimising the impact of public financing

A public representative was concerned to hear that long-term investment is driven by the public side and short-term by the private side. Long-term investments must also engage the private side and so recent legislation must be checked. The EU has been a driving force for developing standards and UCITS was a right approach.

It is important to empower public authorities to make investments as they see fit. Member states need the fiscal space to invest if they want to. The rules of economic governance and those enshrined in the Stability and Growth Pact (SGP) aim to provide space to keep up with regular investments and react in an economic downturn. Rising debt levels in the aftermath of the financial crisis are severely constrained in their ability to act, thus reducing public debt levels by enforcing the current fiscal rules to increase the capacity for public investments when needed.

Private investment is where the biggest impact can be made. The key to unlocking it is removing barriers and obstacles that hinder the taking of calculated risks by providing a high level of regulatory predictability, deepening the Single Market and facilitating access to finance, particularly by completing the CMU, which would also hedge against Brexit impacts. There is no silver bullet to strengthen EU investment capacity; many coordinated measures are needed.

1.2.2. Focusing investment on education and training

The annual European Bank survey asks companies about the impediments to investment, particularly long-term investment. In the last one, the first ranking impediment was the lack of staff skills. Eight out of 10 of the surveyed companies, or 77%, mentioned this as most relevant. Last year's ECB digitalisation survey also focussed on this and concluded that staff lacking the right skills is a significant obstacle to the adoption of digital technologies. Public infrastructure investment should focus on human capital. The Chair noted the strong message sent about social investment in education and training.

1.2.3. Addressing the impediments to investment in some national pension systems and developing the potential of local capital markets

An official considered addressing impediments to investment in some national pension systems to be a priority. It is crucial to maintain momentum and fulfil local capital markets' potential. Incentivising funded pension plans and mobilising household savings into products which support long-term investment is crucial. Allowing the short-term withdrawal of funds from unit-linked schemes is inconsistent with long-term investment strategies.

Another impediment is access to local capital markets in order to improve the availability of long-term financing for local investment projects. Policy engagement and technical assistance on projects improve investment ecosystem infrastructure and reduce listing or transaction costs. Croatia has recently developed a financing platform to support SMEs and start-ups with Funderbeam. That translates CMU potential into practice which will otherwise stay in the realm of concept.

1.2.4. Agreeing on a European Investment Fund of sufficient magnitude to cover needs is key

According to a public decision maker, the European investment stabilisation capacity proposal is reasonable as it can cover the need for public investment in Europe and take a macroeconomic perspective, due to the low stabilisation capacity at the euro-area level. Focussing on investment is crucial as multipliers and expenditure spill overs are high, with positive consequences for long-term growth.

1.2.5. Defining an EU prudential framework, which properly captures the reality of the long-term investment business model

A market expert considered that the existing prudential framework does not properly capture the reality of the long-term investment business model, as characterised by stable financial resources, tight asset liabilities management, permanent asset location, portfolio level management, not line-by-line and remote investment horizon. The investment strategy risk analysis should be redone as it is different from those made for Solvency II and banking regulation, which only concern the short-term perspective. The risks are the same, but their assessment may be different. Liquidity risk exists at a low level when managing for the long run. There is also a limited market risk. There is some interest rate risk for the reuse of resources when the duration of assets exceeds the duration of the bonds. This means that the risk associated with bonds is higher than that with equity because there is no maturity with equity.

Credit risk exists but can be managed. Operational risk is lower as a computer can be out of order for days without an impact. There is economic risk from assumptions made about long-term return and there may be variation, especially for infrastructure, so externalities must be considered. Positives and negatives are linked to the portfolio. The most serious risk related to long-term investment relates to mismatch. Making assumptions about liabilities and the association of assets and liabilities has a significant associated risk. There is also some reputational risk if done on a large scale, as savings collection requires a solid reputation. Financial institutions' prudential framework must be redesigned, with resources for long-term investment.

A Central Bank official agreed that the relevance of market and financial regulation must be acknowledged, as there is an agenda. CMU is crucial for the private sector and the private sector is fundamental for long-term EU investment. The EU and the public sector have a role as there is evidence of public sector under-investment in the EU, particularly in some countries. That shows the importance of euro-area investment capacity to increase long-term investment and act as a stabiliser. The third issue is human capital, which is a combination of the public and private sectors. Human capital is provided by the public sector in many European countries, but the private sector can help to increase it. All these issues must be covered, not just only one.

2. The EU regulatory and supervisory framework needed to foster long-term investment

2.1. Financial institutions' capacity to transform stable resources into long-term investment must not be limited

A market expert noted that it is essential to consider long-term intermediation as the main resource and therefore not to limit the capacity of financial institutions to transform stable resources into long-term investment. Europe relies on powerful intermediation entities that could be combined with the development of market financing to favorably revisit the CMU post-Brexit.

The challenge of long-term investment is that it benefits from a large pool of household savings which are long-term for an aging population, but European citizens are reluctant to directly invest in financial markets. That is understandable seeing what happened on the markets in recent years. Intermediation by large, solid financial institutions is needed to allow them to collect savings and apply them to long-term investment.

Proposals include understanding consumer protection concerning long-term investment and avoiding multiplying the unnecessary liquidity option and restoring financial institutions' reasonable transformation capacity to apply long-term savings to long-term investments through tight asset liability management discipline. Another is redesigning the prudential requirement of long-term investment based on risk analysis and allowing adequate measurement of financial performance by requiring standard-setters to provide practical solutions. That should build a long-term investment strategy, including the comprehensive portfolio approach, the parallel handling of assets and liabilities, and overgenerous treatment of every category of assets to avoid artificial bias in asset allocation to create solid and efficient long-term investment capacity.

2.2. Incentivising companies to be listed is challenging

An industry representative agreed that UCITS is a success that has not been replicated. Stock market regulations include the prospectus directive, market abuse and IFRS accounting, among others. Fewer companies want to be in the stock market. CMU can be discussed at length, but reality shows fewer than 1,000 companies listed on Euronext, down from 1,200 10 years ago, a drop of 20%. There were 300 IPOs last year in Europe and 800 annually before the crisis. The stock market is shrinking.

Legislation plays a role. Ten years ago, it was said that Europe had to emulate the US, where companies are financed more by the stock market than by banks. Europe is the opposite. Companies need access to the stock market and are less reliant on banks. A third way of financing is private equity, which has ballooned. The number of companies listed in the US has also dropped as it makes sense for them to be in private hands rather than publicly listed.

At the end of 2018, a mini bear market acted as a stress test and showed herd behaviour, with retail and institutional investors divesting. There was pro-cyclicality of the Solvency rules and a loss of depth and liquidity. Nothing was learned from that and no discussion happened around it, despite it gifting a real-world experience of what could happen in a true crisis.

2.3. Reviewing Solvency II and accounting standards is urgently required

An industry representative predicted a review of Solvency II as it is meant to be risk-based but puts the lowest requirement on the most dangerous assets. Accounting is key. Companies will divest from equities before IFRS 9 and IFRS 17 enter into force. IFRS 9 will bring volatility into accounts and require funds in the transition of IFS, which requires divesting from equities. This will happen unless the EU changes course on accounting. An urgent proposal is to take back accounting sovereignty in Europe, transform EFRAG into a fully-fledged accounting standard setter and discuss convergence between EU and US GAAP with the IASB.

A public representative agreed there is a long-term lack of strategic and professional investors. Addressing the issues raised will be key. Having more access to private capital is an aim and it is hoped that the next programme will engage with private capital. Solvency II must guarantee that life insurance is available for private investors and that insurance companies can still do long-term investments. Long-term investments are not well-received, especially at EIOPA level, due to requirements making it less attractive to deliver those products. Systems must be recalibrated with the legislation, including PRIIPs.

Another industry leader agreed that IFRS9 penalises long-term projects. It is not possible for banks to have it all. Long-term maturities are heavily penalised by capital requirements, as was highlighted earlier with a comment that long-term is for the government, short-term for the private sector. This is seen in capital requirements so must be reviewed. The CMU project must be fostered in the areas mentioned, including securitisation.

The Chair noted that IFRS is hailed as the accounting standard for transnational and international capital markets but requires revision. The Solvency II review should ensure that long-term investment is stable, secure and does not jeopardise household savings. This must ensure that the EU is stronger than member states if there is global competition.

An industry representative considered that internal models are accessible to the largest groups. €1 billion of assets is too small to have an internal model as it is costly. It cannot compete with groups that can afford an internal model. A public representative agreed that the medium-term requires a discussion about capital requirements, on Solvency II, mortgages and underlying capital. European and international accounting standards must be reviewed long-term so that they are not an additional hurdle.

2.4. Setting up a horizontal review on investor protection

A public representative advised that a horizontal review on investor protection is necessary in the short-term. The aim is to ensure private households, investors and retail clients can invest for the long run and intermediaries can offer products, so both sides must be recalibrated. Europe was a driving force in structures and products. Over the last 10 years, the best disclosure rules on consumer protection were put in place, creating the best-informed clients. Clients may wonder if they are receiving so much paperwork and information on investments because they are not as safe as they were told when it was sold. PEPP is overloaded with disclosure requirements, conservative calibration, fee caps and things which make it less attractive. An unattractive product will not be the market frontrunner.

PRIIPs has similar issues, in that some investments are not accessible for private investors. The legislation enacted shows room for improvement to keep clients informed in a way that they understand because there is a lack of private investors in the capital markets. The Chair advised PRIIPs were not meant to support long-term investment.

An industry representative echoed that the rules reinforce the risk aversion of households. They are warned of short-term volatility and not about the long-term risks of cash. They are also told about fees for investing. It is essential to talk about Solvency II and accounting because nothing has been seen on equity investing and IFRS. PRIIPs requires that retail investors are fully informed of the risks when investing in volatile asset classes. However, the greater long-term risk of lower net returns for savers who eschew equities is not so visible. Investing in equities is costlier than in other asset classes. The transferability of contracts reduces the likely duration of liabilities and thus that of the assets chosen by financial intermediaries to match them. Information about short-term volatility, transparency about costs of equity investing and easy switch of investments between financial providers appear unimpeachable consumer protection goals but may lead retail savers to underinvest in equities for retirement, whether the vehicle to do so is unit-linked insurance contracts, pension products, with profit life policies or UCITS.

2.5. Channelling household savings in the local economy in central and south east Europe

A public decision maker advised that there are multiple strengths in the accumulation of household savings in the countries of operation in central and south eastern Europe, that are well capitalised in a liquid banking system and growing institutional investors' balance sheets. In many cases, the limited supply of local investible assets means that valuable long-term resources are not deployed in the local economy but flow offshore or back into the local banking system as deposits. The greatest challenge and opportunity is encouraging local boroughs to diversify their funding sources and use capital markets.

This means identifying reforms to reduce issuance costs, improve the legal and regulatory environment, develop the financial market infrastructure and the institutional investor base. Another challenge in many European countries is measures that undermine the long-term investment capacity of European institutional investors and local pension funds. This results in barriers to long-term investment, which leads to more dispersion and market fragmentation.

The Chair noted that PEPP is an asset manager product with an EU label that does not guarantee that savings in countries where Pillar 1 or 2 is not developed can enter it. There is a contradiction between using long-term savings but not allowing for proper EIOPA involvement, keeping it under national competent authority control and allowing it to be opened in only one other member state. The loophole in the market would not be filled.

An official recognised that it is important to work at the local and European level on pension funds. Legislation that enables investments with a long-term horizon and with a taxonomy linked to sustainable financing is fundamental to having the same framework within the European area. That does not mean not pursuing the right reforms at a local level, while avoiding reforms that lead in the wrong direction. The right reforms are ones that make local investment in infrastructure easier and widen the size of capital markets. It is important to build the right European legislation to create a truly single CMU, while working on supply and demand from the sub-regional level.

A market expert agreed. Liquidity options and documentation must be reviewed. Onerous documentation requirements do not provide the required level of safety and comfort.

Conclusion

The Chair noted that this was a controversial roundtable and she does not believe that PRIIPs had overburdened the consumer, investor or saver that would not enter the market. Concerns about the shrinking of the stock exchange in the EU and the US were noted. There is a controversial dimension on the role of public and private investment in ensuring the right dynamic for long-term investment but there is a role for both. The EU is still looking for its new UCITS success and pensions can be a driver for long-term investment, but there is a consensus on changing IFRS. This would be her last chairing of a roundtable in Eurofi as a MEP and the Chair thanked David Wright for his earlier comments. It had always been a huge pleasure to chair or to participate in the work of Eurofi, as it is an utmost important contribution to ensuring things are fixed.

The Eurofi President noted that he was using his prerogative for the first time. The Chair has accomplished five mandates in the European Parliament, or about a quarter of a century. Anybody who has worked with her knows her dedication to the EU and sensitivity to European citizens, social fairness, and progressing files in Europe. The last example is the work to strengthen the European supervisory authorities, where her tenacity in the negotiations was noted. It had been a privilege to work together. She is an embodiment of what Europe is and Eurofi salutes her. She will always be welcome at Eurofi.