Developing a stronger European investment capacity

Pablo Hernández de Cos

Governor, Banco de España

Fostering investment and economic growth in the EU

The euro is celebrating its 20th anniversary in a critical moment. The global economic slowdown, the protectionism threat, structural and technological transition in significant sectors, Brexit; they all create a very challenging scenario. Enhancing our overall capacity to resist shocks and fostering long-term potential growth are, in my view, the major challenges facing the EU. Long term growth has followed a downward trend during the past two decades - ranging around 1.5% in the euro area, well below figures close to 2% in the US-. This development has been driven by different factors including low productivity, demographics and particularly the persistent weakness of business investment.

Investment conditions improved in recent years, helped by the economic expansion, favorable financial conditions and public initiatives such as the Investment Plan for Europe. However, according to the European Commission estimates, the investment gap is far from having been closed particularly in higher risks activities, such as research and innovation and infrastructures, crucial for long term growth and competitiveness. In net terms, the investment rate in the euro area is still below 5% of net value added, while the average during 1999 to 2008 was above 7%.

Two factors represent important obstacles for investment activities. The first one is economic policy uncertainty, at record highs in 2018. Global trade policy, Brexit and the lack of decisive steps to further increase integration in Europe, play a role in this result. The second important factor is private and public indebtedness, which remains on average above pre-crisis levels.

At the EU level, both the Investment Plan for Europe launched in 2015 and its successor, the InvestEU Programme, as well as the project of a Capital Markets Union (CMU), could partially address low investment. The Investment Plan has contributed to mobilize resources and to remove regulatory and non-regulatory barriers, but it is hard to think that it will be enough to close the investment gap. In addition, some recent analysis suggest the need to scrutinize projects in a more demanding way, to increase additionality.

The proposals put forward by the European Commission regarding a Capital Markets Union, in parallel with the completion of the Banking Union, are crucial to enhance investment. CMU can complement Banking Union by increasing the volume of available resources and fostering alternative sources of funding, thereby reducing the high reliance of the Euro area on banking intermediation. Increasing depth, liquidity and

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>>> integration in equity markets, will contribute to diversify financing sources and reduce funding costs, offering borrowers and investors a greater variety of instruments and the possibility to channel savings to investment more efficiently.

CMU proposals can be especially relevant for small and medium-sized enterprises, which typically face more difficulties accessing finance, especially when bank credit is scarce or expensive. Measures aimed at helping startups and technological innovation by fostering venture capital and creating an EU framework for crowdfunding are highly relevant. In addition, CMU can aid in raising higher volumes of funds for large investment projects, such as energy and infrastructure, sourced from long-term investors such as pension funds or institutional investors. Finally, developing European-wide markets for ABS and covered bonds can help banks securitize loan portfolios, freeing up regulatory capital and increasing the supply of funds for new loans.

Proposals facilitating cross-border distribution of investment funds are particularly welcome. Greater diversification through capital markets can enhance cross-border risk sharing and alleviate risks of financial fragmentation, and thus mitigating risks of sharp drops in investment. A more coordinated or unified European supervision of capital markets could contribute to achieve this goal.

At the country level, we should keep in mind the vast literature that shows that the highest barriers to investment are related to the domestic business environment: rigidities in labor and product markets, administrative burdens, inefficient judicial systems and insolvency frameworks, the complexity of tax systems and the debt bias in corporate taxation tend to be associated with less investment. ●

Markus Ferber

MEP, Committee on Economic and Monetary Affairs,
European Parliament

Strengthening the EU's capacity to invest

Investments are key to ensure long-term economic growth and the long-term competitiveness of the economy and also in the short run, it pays off following investment figures closely as investments help to create jobs and to boost growth. Therefore, investment levels are figures policymakers and industry are paying very close attention to. During the financial crisis, investment levels all over the world took a severe hit and at least within the European Union, they still have not sufficiently recovered to reach pre-crisis levels again, this is particularly true for private investment. Therefore, policy makers across Europe and beyond have been pondering the question of how to lift investment levels back to or above pre-crisis levels.

When we think about investments, we have to make a distinction between public investments and private investments. While both might have similar effects on the economy at large, public authorities only have a limited and indirect ability to stimulate private investments. Nonetheless, there has been a vivid debate about how to stimulate both public and private investments following the crisis. The most prominent effort was certainly the European Fund for Strategic Investments and its successor vehicles.

While the European Fund for Strategic Investments certainly created a fair degree of media buzz, it is at least questionable if it has so far fulfilled its lofty ambitions of creating more than 300 billion euros in additional investments by leveraging the initial capital stock 15-fold. If you believe the European Court of Auditors' assessment, this endeavor was not entirely successful and it is more likely that most EFSI projects were those >>>

>>> that had been in the final stages of planning and were basically shovel-ready. That means that many of the projects that now bear the EFSI label would have been realised regardless of the EFSI's involvement. Arguably, that means that most investment did not fulfil the criterion to be truly "additional".

What can we learn from this subpar result for future investment funds? Well, after all, EFSI has primarily financed projects that were not too risky and that were ready to implement, i.e. it has financed projects that would have found financing on the market anyway. Probably, in doing so, it has even crowded out potential private investors. Hence, for the next instalment we should make sure that a vehicle such as EFSI can take on a little more risk in order to focus on projects that would otherwise not getting any market financing - that would automatically ensure that we get projects that truly fulfil the objective of being truly additional.

Looking beyond elaborate guarantee schemes, we should also consider how we can empower public authorities to make investments as they see fit. If Member States want to invest, they need fiscal space to do so. The rules of economic governance and in particular the fiscal rules enshrined in the Stability and Growth Pact aim to do just that: providing Member States with enough fiscal space in order to keep up with the regular investment schedule and to be able to react in case of an economic downturn. Arguably, the rising debt levels in the aftermath of the financial crisis have severely constrained Member States' ability to act. Therefore, bringing down public debt levels by rigorously enforcing the current fiscal rules would be a substantial and welcome contribution to increase Member States' capacity to make public investments when needed.

Lastly, when looking at the mere numbers, private investment is clearly where the biggest impact can be made. The key to unlock private investments is removing barriers and obstacles that currently hinder corporations to take calculated risks by providing a high level of regulatory predictability, by deepening the Single Market and by facilitating access to finance, in particular by completing the Capital Markets Union, which would also be a hedge against the impact of Brexit.

There is no silver bullet to strengthen the European Union's capacity to invest. Instead, what we need is a multitude of coherent and coordinated measures. The biggest issues are arguably to improve the enforcement of the fiscal framework thereby creating the fiscal space for Member States to invest and to finish the Capital Markets Union. ●

Cyril Roux

Group Chief Financial Officer, Groupama

Regulation is turning European insurers away from listed equities

Insurance is a long-term business subjected to regulation focused on short-term risk. As a result, insurance companies are led to underinvest in listed equities.

Insurers should choose their assets' duration and expected return in line with those of their (long-term) liabilities. In so doing, insurers would play their natural supporting role in the long-term growth of the economies in which they operate.

A number of factors interfere with this ideal scenario. Since 2016 the first impediment to long term investment is the structure of European solvency requirements. Europe measures solvency exposure to asset risk under a one-year horizon. Investment in long dated assets subject to greater short-term volatility is thus structurally disadvantaged. The long-term guarantee package was meant to counteract this fundamental design flaw of Solvency II. It proved insufficient, so more shock recalibration measures are being added. These measures come with conditions, caveats, and complexities which limit the scope of the relief they provide. Unfortunately, EIOPA fights against these improvements, limited as they are, intends to advocate against such measures during the 2020 Solvency II review.

Other impediments to long term investing derive from well-meant consumer protection measures. PRIIPs requires that retail investors are fully informed of the risks they take when investing in volatile asset classes. >>>

>>> However, the greater long-term risk for savers of eschewing equities, i.e. lower net returns, isn't as visible. Investing in equities is costlier than in other asset classes. Finally, 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. However, they may lead retail savers to under invest in equities for their retirement, whether the vehicle to do so is unit linked insurance contracts, pension products, with profit life policies or UCITS.

Other regulations hamper equity investing. Inventories of equities on bank balance sheets have dried up with the combined effect of liquidity requirements, the quest for collateral and the discouraging of proprietary trading.

"Insurance is a long-term business subjected to regulation focused on short-term risk."

- CYRIL ROUX

Mifid2 has reduced research on small and middle caps. Insurers face European equity markets with surprisingly low depth at times, except for the largest caps. And accounting changes, on IFRS 9 and IFRS 17, will exact an increased toll on the volatility of net results for those insurers ready to invest in equities.

In France, measures enacted to protect renters have turned insurers away from investing in residential housing, which has become for them a residual asset class. Europe would be well advised to weigh the risk that the combined effect of regulation of market research, proprietary trading, financial reporting, insurers' solvency and consumer protection do the same to most listed equities, notwithstanding the lofty aims of the Capital Markets Union. ●

Gérard de La Martinière

Chairman, Long-Term Investment Task Force of the Paris Marketplace

Betting on the long-term: rebuilding investment for the Europe of tomorrow

The Green Paper published by the European Commission five years ago highlighted the importance of long-term investment both for growth and financial stability. A set of initiatives was adopted in the framework of the Capital Markets Union (CMU) project in order to transform modes of corporate financing, mobilise financial markets and exploit and allocate inflows of long-term savings. However, such structural measures could not produce significant results in the very short term. Decades would be required to shift the intermediated financing models that have traditionally reigned supreme in Europe in the direction of a market finance model. Yet in terms of international competition, stimulating long-term investment represents a much more immediate issue.

Until the market finance model becomes the norm, it is essential to better consider the long-term intermediation because it is today the main part of the resource: it is therefore essential not to limit the capacity of financial institutions to transforming stable resources into long term investment. From this point of view, Europe can rely on powerful intermediation entities that, in a post-Brexit context, could be relevantly combined with the development of market financing to favorably revisit the CMU.

The report recently published by the "Long Term Investment Task Force" of the Paris Marketplace[1] shows that adjustments adopted to modify at the margins the succession of grand post-crisis regulations (sometimes detrimental to investment) only partially mitigate the pitfalls of a regulatory system too heavily focused on the very short term, and which ignores the characteristics of their LTI 'business model'. They are just "patches" which limit the damage to some extent, but do not constitute an effective response to the major political imperative of stimulating private investment in the wake of the Juncker plan.

One of the merits of the first generation of European regulation of the financial sector (banking, insurance, etc.) was to leave those responsible for these activities free to choose in the public interest which asset allocations were best suited to client requirements, to the circumstances and the economical context.

"EU must globally address the LTI issue in order to establish an appropriate reference framework."

- GÉRARD DE LA MARTINIÈRE

The principle of asset managers' freedom and responsibility is of even greater critical importance today given the diversification of investment instruments, the heightened financial instability and the enhancement of saver protection. To confront its current economic and financial challenges, Europe has no other choice than to address the issue of long-term investment in a global manner in order to establish an appropriate reference framework.

Finally, it is necessary to reinforce financial literacy and information regarding LTI. Indeed, levels of financial literacy in the different member states are generally low. The reinforcement of financial literacy vis-à-vis both the general public and decision makers is crucial if we are to improve the allocation of savings and should occupy a central position within LTI. ●

1. https://www.caissedesdepots.fr/sites/default/files/medias/en_-_lti_report.pdf

Pierre Heilbronn

Vice President, Policy and Partnerships, European Bank for Reconstruction and Development (EBRD)

Pensions matter for capital markets development

In my last contribution to EUROFI, I made reference to a 2016 OECD study which concluded that unfunded government pension liabilities in its 20 member countries exceeded USD 78 trillion – most of these in Europe. These unfunded pension liabilities are growing and if left unaddressed will place a large strain on future budgetary processes and pensions alike. Why do we then observe a recent trend where in some jurisdictions existing funded Pillar II[1] arrangements are being nationalised rather than extended? And why do countries pursue an unfunded state system when Pillar II acts as an active institutional investor with a positive impact on capital market development?

In fact, funded pension arrangements have been criticised for the following reasons:

- High fees charged by private sector asset managers and advisors that undermine returns;
- Pension risks are borne solely by the individual without regard to the capacity of the individual to assess risk and take complex investment decision;
- Pension funds' overinvestment in government securities creates a financing circularity – the state allocation to private pensions increases the need to issue debt which is bought by pension funds;
- Onerous investment restrictions by regulators mean that returns are highly unlikely to keep pace with inflation;
- Offshore investments by state pension funds (largely due to the absence of domestic capital market investment products) mean that a country's long-term infrastructure financing needs are not funded by long term national savings.

"Viable solutions rest in constructively addressing the identified shortcomings."

\- PIERRE HEILBRONN

Yet, rather than throwing out the notion of a funded pension system altogether, viable solutions rest in constructively addressing the identified shortcomings:

- High management fees can be partially addressed by the establishment of low-cost default funds which would outsource the investment function to asset management firms as an institutional mandate, attracting lower management fees in this way. A large percentage of contributors are likely to favour such funds until they build familiarity with other investment products with different risk profiles.
- Pooling of risks in so-called 'collective defined contribution' plans in which assets (and risks) are managed on a pooled basis could also ameliorate the risks related to the individual taking all the investment risk and choices over how much to contribute.
- Over-investment in government bonds and offshore investments can be partially addressed by a comprehensive capital market development strategy that leads to an expanded array of investment products. This can be a desirable outcome for economies with potentially large infrastructure funding needs, particularly in local currency. Regional initiatives such as Capital Market Union also target the expansion of financial products. Nevertheless, pension funds must have an allocation to safe annuity instruments such as government bonds, although some jurisdictions set maximum investment limits for that asset class.
- Some jurisdictions subject pension funds to UCITs style investment guidelines favouring investments that can be valued daily rather than instruments of a longer duration that can mirror a funds contribution profile and potentially may not keep pace with inflation. Ideally, there should also be an allocation to high growth potential sectors such as venture capital and even commodities. However, some balance of safety and return is advisable.
- Soft compulsion incentives may provide a powerful incentive for wealthier contributors to boost their retirement savings, leaving room for the public pension system to provide improved coverage to the less well-off retiree.
- Finally, any unfunded pension liabilities should be prominently published as an integral part of the national accounts, including year on year positional change according to an agreed standardised methodology. Evidence of this lies in the powerful private sector precedent where disclosure of unfunded pension liabilities in the company accounts, following the recommendations of the Myners report (2001), led to an expansion of defined contribution schemes in the United Kingdom.

In conclusion, funded pension schemes will appear economically efficient and politically desirable compared to unfunded pension promises if and only if such initiatives are implemented with determination. This is the deep belief that guides the operations and policy engagement of EBRD across Central and South-Eastern Europe and beyond. ●

1. Pillar II arrangements are funded pension systems where future recipients and employers pay into. This includes pension funds and defined contribution accounts/plans with a wide array of design options.