Note drafted by the Eurofi Secretariat

DEVELOPING A STRONGER EUROPEAN LONG-TERM INVESTMENT CAPACITY

1. Long term investment remains below pre-crisis levels at a time when the challenges facing the EU demand an unprecedented investment effort

More than 10 years since the eruption of the financial crisis, growth has finally returned – on the whole – but investment, and especially long-term investment, is yet to reach pre-crisis levels. The challenges the EU is facing require an unprecedented long-term investment effort, where stable capital is key to finance the tangible and intangible assets we need for the future. It remains sluggish at a time when the challenges indiscriminately faced by the EU - accelerating technological innovation via the digital revolution, climate change, an ageing population, emigration issues, the renewal and extension of infrastructure, European security and defense requirements…- demand an unprecedented investment effort in a context where some significant countries are very highly indebted and the households are generally risk averse and prefer to build up a savings buffer that is liquid to a great extent.

Paradoxically the euro area exhibits a savings surplus of more than €300 billion, or 3,5% of GDP in 2017, which is no longer being lent to the other euro-area countries but to the rest of the world.

At the same time, the challenges faced by the EU financial system 10 years ago, which are still pending in some areas, have led regulators and supervisors to put the onus on "financial stability". This work program was defined by the G20 Financial Services Board in the main sectors concerned (banks, insurers and CCPs) by the approach "solvency, systemicity, resolution".

As this 10-year effort in financial regulation has now largely reached its objectives, with a conceptual focus on the resistance of single entities to default through a reinforcement of their own funds, it is time to open the discussion on to other policy objectives and tools.

2. If the EU wants to be sovereign and prosperous, it must strengthen its long-term investment capacity

A radical change and a strong political impetus are therefore needed. A coherent and comprehensive long-term investment policy is essential to close the gap. Public funding cannot be sufficient to close this long-term investment gap. The results of the "Juncker Plan" underline that the mobilization of public funds is not equal to the financing challenges and encourages the exploration of other techniques in order to optimize the effect of public funding.

It is also imperative to remove prudential and accounting constraints that prevent financial institutions from channeling savings collected towards long-term investments. In this perspective, better understanding and defining the nature and specificities of the long-term risk and its dedicated prudential framework is an urgent priority.

More generally, such a stronger European long-term investment capacity requires not only a shared political vision on the key industrial strategic choices for the essential sectors (renewable energies, the circular economy, digital, new technologies…) but also financial players of sufficient size and competitiveness who can rely on a truly integrated financial market, appropriate prudential and accounting rules that do not discourage investment in equity in particular, adequate investment products and efficient provision of retailed investor information and advice provided by financial intermediaries.

3. Optimising the impact of public financing

Public funding is compulsory but cannot be sufficient to close the long-term investment gap in Europe. The political challenge has to go well beyond the need to ensure the real "additionality" of the projects financed by the "Juncker Investment Plan". With an initial contribution of €21 billion, it has mobilised €335 billion over three years, which has boosted investment in Europe. But the results of this EU initiative also underline that the mobilization of public funds is not equal to the financing challenges and invite to explore other techniques to optimize the effect of public funding.

Europe must define and implement economic and financial conditions in order to free up public and private initiative. Public authorities play a central role in long-term planning. They are the only ones capable of addressing the uncertainties related to the long-term strategies put in place to address for instance energy transition challenges (such as the choice of the proportion of nuclear power according to the sensitivity of voters, the reweighting of the share of wind power, etc.). This is the reason why the public guarantee must be applied in a preferential manner to cover the uncertainty risk (notably political) associated with the long-term forecast. In this perspective a public insurance mechanism should certainly be a right way forward.

This scheme should mitigate the uncertainties linked to the industrial strategic guidelines provided by public decision makers. The challenge is to go beyond the direct participation of the public authorities in the financing of these investments. Indeed, only an EU insurance mechanism would enable project sponsors and their financiers to commit to long term investments. These are the conditions for achieving an effective additionality

of the projects made possible by the intervention of the public sector.

4. **Prudential and accounting standards should acknowledge that the long term does not entail greater risk, but presents a different risk profile, which needs to be analysed and calibrated in a specific way**

Prudential and accounting regimes for long term investment, whether they relate to banks, insurance companies or those governing the distribution of funds associate long-term with high levels of uncertainty and focus on market and liquidity risks. But we have to keep in mind that long term reflects the very nature of our financial institutions, which are here to stay and which clients shall be able to trust upon. The average duration of the liabilities is close to 14 years for European life-insurers, for example. Against this background, is that such a problem if a life insurer invests more in equities, which holding period is currently around 4,5 years, or in a private equity fund whole holding period is currently close to 6 years?

This is the specificity of long-term financial players: for them, there is no contradiction between matching their liabilities and holding their long-term investments to maturity, contrarily to a "trading book" approach reflecting mainly market risks. In this context, prudential frameworks shall develop more "hold to maturity" or "hold to duration" asset classes allowing for reduced market shocks, with criteria protecting these asset classes absent short-term, trading book-like shocks. Another specificity is a potentially countercyclical investment behaviour of these players through the financial cycle and investment choices voluntarily abstracting from short term volatility and selecting assets on the basis of their yields on the long run : this means also that penalizing the assets invested with this strategy in prudential framework for their bigger volatility (or illiquidity) is a great mistake (sadly made very recently by the insurance International Capital Standard, which will contain a specific volatility shock for equities). Last point: entities investing in the long term, for decades, for example pension funds, sovereign funds or insurers holding pension risks, are the only ones able to finance long term activities and projects with positive returns for the society as a whole, like infrastructures, private placements, venture capital or projects for the energy transition in general.

Moreover, current risk assessment systems only depict the future as an occurrence of the phenomena witnessed in the past. This proves particularly inadequate to capture long-term risks such as the current climate-related disruptions, the risks of which are linked to the socio-economic adaptations and numerous and competing technological challenges. More emphasis shall be put on prospective supervisory tools like the insurance ORSA or recovery plans in resolution.

The construction of a coherent system of evaluation but also of the management and mitigation of long-term risks is urgently needed. This system must be specific to actors who are not subject to short-term risks. In such a context, better recognizing and defining the nature and specificities of the long-term risk and defining the dedicated prudential framework is an urgent priority, as well as defining explicitly its objectives. Such a long-term framework must be open to all financial players likely to have a long-term investment strategy based on stable resources and also on the reality of long-term risks as well as on a performance measurement consistent with the duration of the investment. ■