SESSION SUMMARY - HELSINKI SEPTEMBER 2019

Tackling long-term investment disincentives

1. Europe must incentivise long-term investment

An official considers the subject of how to tackle long-term investment disincentives one of the 'most philosophical' subjects at Eurofi, because there are myriad answers to this question. However, long-term investment is extremely relevant for Europe. The official described the puzzle currently plaguing Europe, in which low interest rates should mean that companies are easily able to find and invest in projects with positive net present value, i.e. they are easily able 'to get rich'. However, this is not happening. An industry representative stressed that banks and insurance companies have an essential role to play in tackling long-term needs, particularly because the Capital Markets Union (CMU) is still unfinished. The official emphasised that more than 65% of the European economy is financed by banks.

1.1. Europe must be able to finance both the energy transition and digitalisation

An industry representative noted the broad agreement on the need for long-term investment. There are challenges around digitalisation, the environmental transition and the need to develop pension infrastructures. The cost of the environment transition was recently estimated at €175-250 billion per year over the next decade. Another industry representative agrees on the importance of global challenges such as the trend for greater digitalisation, the emergence of new players in the market and the environment transition. An official emphasised the substantial investment required for both climate change and digitalisation.

1.2 The ongoing macroeconomic climate is not conducive to long-term investment

An industry representative outlined several problems in the current environment, highlighting low interest rates. Some firms are using 'easily 25%' of their own funds to meet the increased market values of these liabilities; this demands a considerable amount of capital. When interest-rate liabilities absorb this level of funding, there are limited remaining opportunities to use capital to make long-term investment commitments. An official queried the cause of the present macroeconomic climate, what the low interest rate shows and why people assume the return on a discount is any bigger than zero. This zero is not an accurate reflection of the situation, but it illustrates that something is burdening the industry.

2. To what extent does Europe's regulatory framework cause long-term investment disincentives?

2.1 The impact of regulation on long-term investment

An industry representative considered that the financial crisis revealed excessive leverage, improper liquidity management and insufficient capitalisation in the banking industry, but this has been addressed and financial stability has been reinforced. However, post-crisis regulation and reform were implemented without a strategic consideration of their long-term economic impact.

2.1.1. There are strong regulatory disincentives to equity investment

An industry representative highlighted the impact of regulation on equity portfolios. Under Basel IV, equity risk weighting will increase significantly for banks applying the standardised approach: 75% for equity investment funds and 60% for equity investment. Financing technological innovation and sustainable development is generally done using equity investment; this increase could lead to banks reducing their holdings or even exiting these activities. Another industry representative agreed, describing how insurance firms are divesting from equities because this is the major adjustment available to insurers in an environment of declining regulatory ratios. An official viewed it as problematic that insurers are disinvesting from equity to meet their capital requirements. This means eliminating the prospect of higher returns for savers. Furthermore, in terms of financial stability, equity is a countercyclical buffer. If the insurance industry cannot invest in equities, it is unclear who will. Banks will not make these investments. Direct investment is possible, but savers do not want to over-invest directly in equity, which means financial intermediation is necessary.

2.1.2. In specialised lending, LGD input floors are of particular concern

An industry representative explained how the standardised approach for specialised lending in the latest Basel III reforms would impose probability of default (PD) and loss given default (LGD) input floors. This asset class has historically experienced a low level of default and a high recovery rate, but the new rules will have an estimated 30% increase in risk-weighted assets requirements. While a supporting factor was introduced into the regulation for safe and sound infrastructure, the EBA estimated that less than 3% of exposures would benefit from this. These capital constraints would more likely lead banks to revisit their strategy in specialised lending, which is paradoxical given the need for investment in this area. Banks would also be subject to a floor requirement on risk-weighted assets to enhance the comparability of risk-weighted capital ratios. This is a backstop which will further limit the investment capacity of banks using internal models.

A member of the audience highlighted the importance of specialised lending in financing the energy transition through its role in infrastructure project finance. The strong increase in risk-weighted assets (RWAs) experienced by banks implies a reduction in the volume of loans granted in this area. Banks in France and more widely in Europe expect an increase in RWAs of much more than 30%. The infrastructure-supporting factor with a 25% haircut does not compensate for this. In terms of infrastructure, the S&P study shows that over half of defaults have an LGD below 10%. Applying a 25% LGD input floor would make these transactions impossible to finance. The EBA should develop an adequate framework which is in line with the risk. Additionally, the criteria for infrastructure assets are too restrictive. It is important to develop criteria that can address the specificities between different projects.

2.1.3. Europe's regulatory capital requirements are excessive notably those related to securitisation

An industry representative considered the implementation of Basel III, known as Basel IV, will require a 25% increase in capital requirements, which adds to a capital requirement that has more than doubled since 2008. Considering the capital requirements under Solvency II, another industry representative provided a comparison of single-B capital requirements under Solvency I with AAA capital requirements under Solvency II for a senior tranche of a non-STS securitisation: the figures are 62.5% versus 38%. This makes it impossible for banks to securitise infrastructure loans or project-finance single-B loans and sell them to insurance companies, because the regulatory capital will be significantly higher. Additionally, regulatory capital for residential mortgages will be lower than the regulatory capital for the AAA tranche of that mortgage portfolio, which makes no sense for liquidity and credit.

An official wondered whether the primary law concerning capital requirements was not drafted incorrectly. The industry representative explained that many of these capital requirements were developed in silos. The requirements for covered bonds, the loan requirements, the requirements for corporates and the securitisation requirements were all developed separately, and their consistency and cumulative effect was not considered. The industry representative illustrated further such an inconsistency explaining that there would be a problematic effect caused by the banking regulation in terms of a maturity adjustment of risk weights. Moving from one year to five years increases the capital required between 30-50%, whereas in covered bonds or banks loans moving up to 20 years does not have this increase in capital.

An industry representative stressed the importance of securitisation. The EU's solution to securitisation was the adoption of simple, transparent and standardised (STS) securitisation. Securitisation could address a wide variety of issues, including liquidity, infrastructure finance and green finance. However, at the end of August there were 44 STS securitisations on the market, of which two were first-time issuers. The other 42 came from repeat issuers who use securitisation as part of their business models. Additionally, there was a long delay in the introduction of STS. The securitisation law came into force before the enabling regulations were ready. The reality is that many of the enabling regulations will not be ready until a full year after the securitisation law will have come into force. This creates uncertainty in the market. The industry representative suggested that the forthcoming review of Solvency II and the final adjustments to the securitisation regulatory technical standards could provide an improvement which would enable banks to use securitisation to address long-term funding issues. However, there is continued negativity around securitisation.

A policymaker considered securitisation the great low-hanging fruit of the 2015 CMU action plan. The fruit was low-hanging but very firmly attached to the tree, so it was possible to reach this fruit but not to pick it. Europe has to make these kinds of trade-offs. After the financial crisis, securitisation had 'enormous negative baggage'. The Commission argued that the European experience was entirely different, but there was no traction because of the general sense that securitisation was responsible for the crisis. Bringing securitisation back in any sort of easy way was therefore not acceptable. Even the Commission's precisely calibrated and careful proposal was subject to further calibrations, and the result left nobody happy. The policymaker suggested that the Commission should look at this again, perhaps in a revamped CMU.

2.2. Other structural disincentives to long-term investment

2.2.1. Europe's approach to monetary policy negatively affects long-term investment

An industry representative felt that current monetary policy is a 'self-inflicted blow', considering it increasingly less understandable why central banks seek to increase the rate of inflation from current 1.2% to close or below 2%. The ECB's mandate is to ensure the stability of the euro and seeking ever-lower interest rates is moving into 'Alice in Wonderland territory'. Central banks must change their approach. An official agreed that any continued period of negative interest rates would create difficulties for the financial sector, adding that the ECB is well aware of this. Another official noted that Europe has been in this position for a long time, which means it is time to consider making structural adjustments rather than waiting for the situation to change and hoping there will be no adverse consequences.

2.2.2. High importance given to liquidity risk management in Europe

An industry representative noted the importance of liquidity risk management. Firms are using their own tools, some which are built on worst-case scenario's. If a company promises liquidity to customers, it must provide that liquidity while ensuring it has enough liquidity for itself. As it is logical for insurers to hold illiquid assets, there is a need to assess the possible liquidity risk in case of a worst case scenario. Given that consumers cannot buy back their insurance at the value carried on a balance sheet; there must be a deduction. The official suggested that this problem is different in different European markets. An industry representative agreed, emphasising that liquidity risk is magnified by fragmentation. Also, the help of national crisis legislations, in countries where these exist, which can prevent customers withdrawing their saving under crises can be an important protection tool against liquidity risk, an official suggested that liquidity is also a 'hot issue' in discussions about banks. Another industry representative described how their institution had never had a problem with liquidity before, but now it is over-liquid.

2.3 The challenge for the Commission: striking a balance between financial stability and incentivising long-term investment

A policymaker stressed that this is not the first time there has been a discussion on long-term investments and the obstacles created by regulation in a Eurofi panel. Long before the environmental, social and governance (ESG) agenda, there was a desire to promote long-term investment in the European Union. The crucial issue is to find a better balance between long-term investment maturity and the market's short-termism. This has always existed, and it demonstrates why Europe must reinforce the long-term growth potential of the economy. The European Commission is somewhat 'schizophrenic', because it is responsible for financial stability and other financial risks while also being responsible for developing policies that promote growth. The Commission's approach is based on the logic that even the most apparently substantial long-term investment is not sustainable if the system is not stable. Stability is the fundamental condition for sustainability. The Commission manages this by turning to its experts. The Commission asks the supervisory authorities to provide advice on how to strike this balance and whether it needs to recalibrate; it receives the advice and determines what to do, and sometimes it goes further than the advice it is given.

There are issues around financial regulation being an obstacle to long-term investment. However, when Europe has made adjustments, including a recalibration of capital charges, the elasticity of response to these has been very low. This recalibration has not produced a surge of institutional investment into infrastructure. There are two possibilities here. The first possibility is that there must be a much more substantial trade-off. This would suggest that the impact at the lower end of the curve is non-linear and there will be no reaction until there is a significant recalibration. This implies a much more pronounced trade-off within the conundrum concerning stability and growth. The second possibility is that regulation is less important than is often suggested. It is important to ask whether regulation should be the focus of this debate.

An official considered that the financial crisis demonstrated how important it is for financial entities to have sufficient balance sheets to absorb shocks. Such shocks can be absorbed by balance sheets with long-term liabilities and assets. This must be the first line of defence for private entities.

An official feared last Europe could shift too much to the public side on investment while protecting the use of public money in times of stress.

3. Looking forward: next steps for regulators and market participants

3.1. Are further regulatory changes required notably regarding equity investments?

An industry representative stated that the EBA could be given a mandate to consider how Europe can meet its objective of encouraging sustainable development, incentivising long-term investment within banks, while remaining in line with actual risks.

Another industry representative suggested that some regulatory changes are needed for insurance companies to ensure that firms would still be able to provide products with options and guarantees. An official felt that insurers are uniquely qualified to invest in equity, but there is a need for regulatory incentives for equity investment. Another official emphasised that the current position of equity on the balance sheets of financial intermediaries is unsatisfactory. The first official noted that the French and Dutch Treasuries have suggested tackling the disincentives concerning equity in the forthcoming Solvency II review. This review will be important. Supervisors must do their job, but Europe must take a longer-term perspective in its regulations. It is up to ministers to insist to the Commission that there must be a time horizon which is more relevant than one year. A policymaker described how the Commission accepted that insurers should hold equity portfolios but rotate individual equities over time by focusing on average duration rather than absolute duration.

An official suggested that the industry is aware that the public and private sectors can share the necessary long-term investment, which is connected to the next phase of the CMU. If people are supposed to invest more, there must be assets for them to invest in. There must be prospects and there must be a future. This would trigger investment. Europe must clarify why it needs long-term investment, and private entities must be able to continue to make these long-term investments. Europe will eventually create near-term financial stability risks if its regulations are pro-cyclical or if they hinder long-term investment. There is a risk that Europe might create these near-term risks and destroy its capacity to invest in the long term. An industry representative agreed on the need for the CMU, suggesting that it is critical for insurance. The European capital markets are too small and too close to global cash flows. Currently in Europe there is more de-listing than listing, which is a negative development.

3.2. Regulators and supervisors must understand the limits of regulation: regulation can neither eliminate all risk nor solve all problems

An official felt that regulations should not shy away from risk-taking. The current problem of regulation is that regulators and supervisors seek to overachieve. The regulator sector seeks to achieve too much with very few pieces of regulation. The official described how Estonia possibly made a mistake in its compulsory pension system. The legislation sought to include all of the long-term and short-term benefits for the consumer, and the outcome has arguably been suboptimal. The official felt that the same happened in larger European regulations such the Markets in the Financial Instruments Directive (MiFID) or the regulation on the investment-fund: for example, seeking to preserve liquidity for retail investors should bring some benefits, but the market might lose something elsewhere. Another official agreed, describing how Austria has a similar pension product, which is supposed to provide excellent long-term returns, to have an excellent capital guarantee and promote the Austrian capital market. However, it does not produce yield because it cannot achieve several conflicting goals at once.

3.3. There must be an adequate balance of public and private investment

Another official felt that Europe must consider whether the funding for priorities such as the energy transition should be exclusively public or not. These issues create many challenges for member states, depending on their geography and historical situation.

An industry representative agreed on the importance of the private-public discussion. Indeed, institutional investors seek to invest in a variety of investment projects, but the political risk at the start of some private investment projects is something a company must be very cautious about. After this the investment project becomes more stable and has the potential to attract investors much better. New solutions could be done to solve this issue. ●