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EPFSF Briefing

"How can financial services contribute to fund economic growth and to achieve the EU 2020 agenda?"

Introduction

Five years into the financial crisis, economic growth remains low or in decline across Europe. Contraction of output leads to increasing unemployment, declining incomes, lower asset values and lower pensions in many European countries.

Economic recovery is an essential part of today's debate, and all stakeholders agree that the financial sector must play a central role in fostering this recovery.

The European Commission issued on 3 March 2010 its vision for the medium term growth agenda, the Europe 2020 Agenda, calling for smart, sustainable and inclusive growth. The EU set targets for five objectives centrally – on employment, innovation, education, social inclusion and climate/energy – to be reached by 2020. Each Member State sets its own national targets in each of these areas. Concrete actions at EU and national levels underpin the strategy.

This briefing explores how the financial sector's core functions help provide the funding role for kick-starting growth and acting as the catalyst for the Europe 2020 agenda.

Financial Intermediation

Banks, insurers and asset managers have traditionally played different roles in financial intermediation.

Banks in Europe play an important role in providing long-term financing. They typically make long-term loans from deposits. With an increase of short term deposits, a process of maturity mismatch or credit transformation may be created. This maturity and liquidity mismatch means that in the unlikely case that a bank's creditors (depositors) start to withdraw their funds at an unexpectedly high rate – i.e. a bank run – the bank will be unable to liquidate its assets fast enough with a risk of defaulting on its obligations to its creditors. However, as banks often have a local presence, providing long-term experience in financial intermediation, their role as financial intermediaries should be strengthened to support long-term financing.

The liabilities of insurers – whether in annuity commitments in life insurance or in liabilities under a general/non-life insurance policy – are most often long-term and less liquid than the assets backing liabilities. The profile and the characteristics of insurers' liabilities are important parameters based on which insurers make investment decisions. Both the maturity and the illiquidity profile of insurers' liabilities enable them to invest the streams of premiums they receive from their policy holders in both liquid tradable assets such as government bonds, high-grade corporate debt and equity, as well as in long-term illiquid assets such as infrastructure. Moreover, insurers' liquidity is significantly enhanced by both the continual inflow of premiums as well as by investment income – dividends for equity or coupons for bonds. This means that appropriate asset liability management enables insurers to cope well with liquidity.

Asset managers act as an important conduit for channelling savings from both institutional and retail clients to long-term investment needs. Asset managers do not invest off their own balance sheet but act as agents in a fiduciary capacity for their clients, whose assets are typically held in third-party custodised accounts. The majority of strategies run by asset managers are designed to meet long-term investment horizons, taking into account individual client reaction to markets and on-going liability and liquidity needs.

Post-crisis prudential regulation

Following the financial crisis, prudential regulation is being tightened globally. Banks will be required to increase the amount of equity they hold against risk-weighted assets, up from a minimum of 2.5% of core Tier 1 capital under Basel II to 9% under Basel III, implemented in CRD IV in the EU. Additionally banks must reduce maturity mismatching by holding more liquid assets. Basel III's Net Stable Funding Ratio rules require to significantly increase the portion of their liabilities that are stable, or given the scarcity of stable funding, to reduce their illiquid assets, such as loans to SMEs.

While Solvency II is not a response to the financial crisis (it has been in development since 2001), it is expected to require European insurers to hold more capital against certain (long-term and illiquid) assets: including, notably, long-term corporate debt or infrastructure assets. Currently envisaged capital requirements for bonds under Solvency II increase with duration and reflect therefore a high cost for insurers able and willing to hold assets for long-term. Moreover, under Solvency II the balance sheet volatility issue is as important, if not even more important, than the capital requirements. If not addressed, balance sheet volatility will discourage any long-term investments, (nearly) independent of capital charges, because companies will not be able to manage this volatility, which also heavily increases with duration. In this respect, the matching adjustment, which is one of the measures of the currently tested long-term guarantees package, is aiming to capture the long-term nature of insurers' assets and liabilities.

The prevailing hypothesis is that the financial stability benefits of stricter capital requirements for banks and insurers will outweigh the costs of reduced investment.

In addition to assessments of the effect of the new prudential regime (Basel III, and Solvency II) on growth financing, changes in taxation rules and new instruments geared toward the provision of long-term finance could also be considered.

SME finance

SME access to finance is essential to restart economic growth. As has been widely reported, in the EU (as opposed to the US) bank intermediation has largely fulfilled the role of funding provider to SMEs. However, as outlined above, new prudential rules have made the provision of finance to SMEs more challenging for banks. As a result, many banks are in the process of reducing their exposure to higher risk and illiquid assets, such as SME loans.

Filling the lending gap left by banks will require innovative solutions for alternative sources of funding. Institutional investors can make important contributions to bridge the gap in SME financing, although insurers and pension funds tend to focus on higher quality and longer-term assets, both equity and debt, of larger companies.

Market finance is still underdeveloped in the EU, compared to the US for example, but has the potential for growth. Capital markets could provide numerous benefits to SMEs and their investors. However, there are obstacles mostly due to the small scale of the SMEs. The EU institutions are attempting to address these issues in the relevant capital market rules for SMEs as well as in other initiatives (e.g. the Commission's Directorate-General for Enterprise and Industry's works on SME access to capital markets).. EU legislation and the market structure it designs should allow for local financial ecosystems including local players, be they banks, other direct investors, or markets, to remain present and active in meeting the financing needs of SMEs, which are per definition local.

Other measures being contemplated focus on the business angel and venture capital areas.

Long-term investment

There are a number of competing definitions of long-term investment, as acknowledged by the European Commission's recently published Green Paper, which looks not only at infrastructure but also at investment strategies which can support business growth and development over a number of business stages. It is therefore important to consider long-term investment in the round and not focus purely on one or two asset classes.

The economy's long-term investment needs are significant and filling those needs is essential to restore economic growth. Governments and banks face difficulties to support long-term investment in infrastructure, climate change, education etc. with institutional investors (insurers, pension funds) not yet placed to fill the gap in this market. The European Commission wants to interact with stakeholders on measures that could enhance supply of long-term finance. With respect to possible future regulation, it is important to ensure however, that the regulatory framework will create a level playing field for all parties providing long term financing.

The financial sector prudential reform (Basel III and Solvency II) does not encourage long-term infrastructure investment. While the liquidity rules in Basel III will shift banks' attention to short-term liquid assets, Solvency II may have the effect of restricting insurers holdings of BBB rated bonds (which is the typical rating for bond infrastructure projects).

Industry welcomes the European Commission's and European Investment Bank's Project Bond initiative, which provides credit enhancement for projects and promotes risk sharing between financial partners. Other solutions, such as a European private placement regime should be considered. Fundamentally, long-term investors particularly welcome a stable and reliable legal and regulatory framework.

However, industry is very concerned at the recent proposal for a financial transaction tax (FTT) in eleven Member States. While the proposal is targeted at the financial services sector, it would impose direct and indirect costs to the real economy, and to pensioners and savers. The official Commission impact study concedes the FTT would reduce, not increase, long-term economic output.

Policy measures to encourage growth funding

The following are some of the possible measures to consider which target funding constraints. Some are narrowly targeted and would take time to yield results, but collectively they could contribute towards a long-term improvement in funding markets.

- **SME targeted initiatives**
  - EU wide or national SME aggregation agencies;
  - Aggregated funds for investors to support SMEs;
  - Government backed subsidies or guarantees for SME finance.
  - Removal of tax disincentives
- **Non-bank investment in European infrastructure debt**
  - European mandated standardisation of project finance terms, e.g. credit lines, procurement procedures;
  - Ensure Solvency II risk calibration not overly punitive for long term illiquid assets;
  - Review incentives for non-bank investors in infrastructure (capital charges, maturity matching, asset eligibility for funds, etc.).
- **Encourage corporates to invest in growth**
  - Clearer EU and member state position on agreed major growth priorities;
  - New instruments which separate corporate and country risk, enabling fair pricing for strong corporates irrespective of HQ location;
  - Government support and incentives for supply chain financing.
- **Expansion of the European private placement market**
  - Development of pan-European private placement (PP) trading platform;
  - Private placement deal database;
  - Standardised PP documentation across Europe.
- **Institutional investor access to loans**
  - Establish a syndicated and whole loan trading platform, to help maintain secondary market liquidity;
  - Cross border pension pot portability.

Long-term investment and retirement savings

The development of new long-term savings and investment products, such as the creation of long-term investment funds (LTIFs), should also be considered as one option to channel savings toward long-term investment needs.

This said, investing in long-term, illiquid assets implies a number of constraints in particular in terms of liquidity and redemption rights. For this reason, whilst institutional investors may be interested in investing in LTIFs as a way to gain exposure to new asset classes that are less correlated to financial markets, the vast majority of retail investors will likely have a limited appetite for this type of asset, unless they obtain tax advantages in return, such as those usually granted to retirement savings. One solution to overcome this problem could be to explore linking LTIFs to retirement savings.

27 March 2013

EUROPEAN PARLIAMENTARY FINANCIAL SERVICES FORUM

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

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