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Regulating Long Term Finance in the European Union: Challenges and Opportunities

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Regulating Long Term Finance in the European Union: Challenges and Opportunities

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Content:

1. *What is needed in Europe?*
2. *Why is there a problem?*
3. *What are the European initiatives to provide more long term funding to the economy?*
4. *Will these initiatives be successful and sufficient?*

1. What is needed in Europe?

Long Term Finance (LT finance) refers to the activities that channel the savings of the economic operators such as private households, corporates and governments to long-term investment opportunities. On the demand side, the real economy requires long term funding; on the supply side, the financial system provides financing. The extent to which the supply of LT finance matches the demand is an important issue. If the supply is insufficient, it can become a major hurdle for economic growth.

With the financial crisis, the demand financing has been affected. A reduced demand was observed from SMEs, Private-Public Partnerships and other investment projects. On the supply side, risk aversion has increased and banks deleveraged. As a result sub-optimal situation has emerged with low levels of LT investment and financing (EC, 2014a).

Europe, now even more than ever, needs economic growth. Promoting growth requires investments in long-term assets that support sustainable expansion of the economy, such as infrastructure, buildings, factories, education, research and development. The need for long-term finance is therefore motivated by the fact that long-term investment is necessary to promote growth, and that growth is currently a major challenge for the European Union.

According to G30 (2013)[1], an ideal market for LT finance relies on four key principles:

(1) *"The financial system should channel savings from households and corporations into an adequate supply of financing with long maturities to meet the growing investment needs of the real economy;*
(2) *Long-term finance should be supplied by entities with committed long-term horizons;*
(3) *A broad spectrum of financial instruments should be available to support long-term investment;*
(4) *An efficient global financial system should promote economic growth through stable cross-border flows of long-term finance, supported by appropriate global regulation*".

In order to assess the investment needs of the real economy in the EU, we provide hereafter a series of graphs and figures that reflect the need for growth in Europe, and the associated investments that are necessary. We specifically identify investments in both infrastructure and SMEs as two important sources of needs for LT finance.

[1] G30 refers to a working group of thirty personalities from the financial sector around the world. The G30 provides recommendations regarding international repercussions of decisions taken in the public and private sectors.

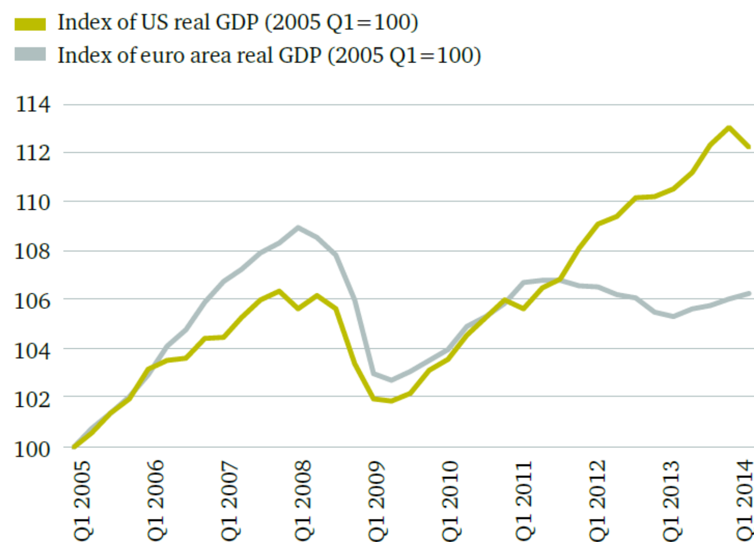
Europe needs economic growth

Figure 1 represents the evolution of the euro area real GDP over the past 10 years, compared to that of the US. Year 2005 is taken as the point of reference, GDP is then expressed as the percentage of this reference. As we can see on this figure, GDP growth in the euro area was systematically higher than in the US. With the financial crisis in 2008, followed by a recession, GDP went down in both regions. The recovery after the crisis was leading to similar GDP growth in the US and the Eurozone between 2009 and 2011. That recovery continued for the US, but stopped in the Eurozone because of the Eurocrisis. Even if there have been significant improvements in the Eurozone economic outlook since 2014, Europe seems to be still fighting to recover from the two successive crises with a much lower GDP growth.

Is the slower growth of Europe in comparison with the US just a temporarily phenomenon that will automatically disappear when the Eurocrisis is over, or is it structural? Well, the discussion about the underperformance of European economic growth is actually not a new phenomenon and a clear answer is essential to define the right policies to tackle the problem.

Anyhow, the fact that banks had to deleverage after the crisis, combined with the extreme importance of the banking system for financing the economy in the EU in comparison with the US, was a major hurdle for the recovery of the EU economy. The dependency of the EU economy on bank finance is considered by many analysts as a structural problem. As argued by Chatham House (2014), "it is not obvious that credit, and notably bank credit, should become the driver of growth (ever) again".

Figure 1: Real GDP between US and euro area



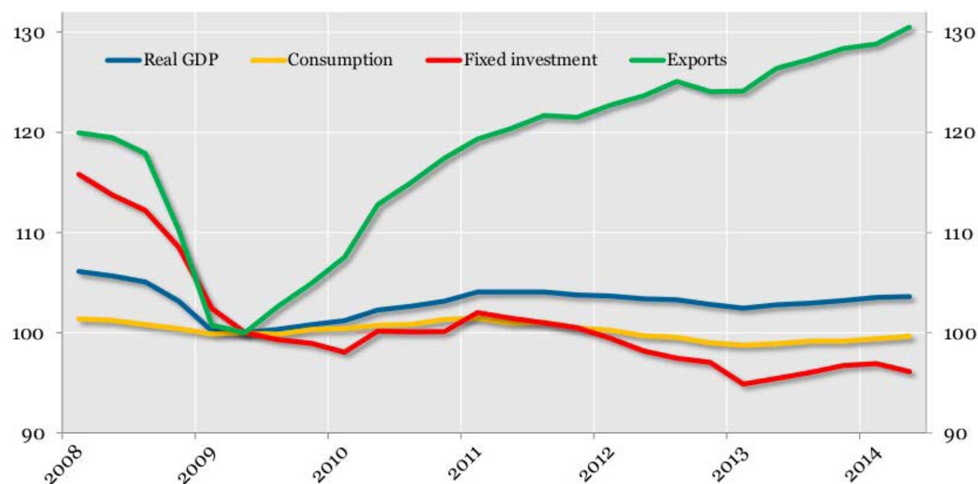
Source: *Chatham House, 2014; Oxford Economics, 2014*

Europe needs investment

As we saw in the previous paragraph, Europe is having difficulties to recover from the 2008 and the 2011 crisis in terms of economic growth. One important driver of economic growth is investment. Typical investments that enable the expansion of the economy are investments in infrastructure, buildings, factories, education, research and development.

Let us have a look at the evolution of the investments in the EU over the past few years. On figure 2, we can compare the evolution of fixed investment in the Euro area since 2008 to the evolution of GDP, consumption and exports, with 2009 being taken as a year of reference. The presented graph is taken from the OECD Economic Outlook 2014.

Figure 2: Euro area GDP, exports, consumption and investment
(Volume indices: Q2 2009 = 100)



***Source**: Mann (2014), OECD Economic Outlook database*

On Figure 2 we observe that the 2008 crisis was accompanied with a significant decline in fixed investment, together with GDP, consumption, and exports. While EU exports have now fully recovered and are even reaching a higher level than before the crisis, fixed investment worryingly keeps on declining.

Hereafter we provide more details on two investment types commonly recognized as enabling economic growth. Firstly, we focus on infrastructure investments in Europe; secondly we have a closer look at SME investments.

Infrastructure investment needs

Before digging into the assessment of infrastructure investment needs, one important issue is the definition of what we refer to as "infrastructure". Indeed, as emphasized in Inderst (2013), the implicit and explicit definitions of infrastructure vary widely in practice. According to the *American Heritage Dictionary of the English Language*, infrastructure refers to "*the basic facilities, services, and installations needed for the functioning of a community or society, such as transportation and communications systems, water and power lines, and public institutions including schools, post offices, and prisons*". Depending on its context of use, infrastructure is generally defined along the lines of:

- "*physical characteristics (roads, bridges, pipelines, cables etc.)*
- *industrial sectors (including economic infrastructure sectors such as transport, energy, water and waste; sometimes also social infrastructure such as education, health, security buildings)*
- *economic characteristics (such as large, capital-intense monopolies, high barriers to entry, economies of scale, inelastic demand for services etc.)*
- *investment characteristics (such as attractive returns; low sensitivity to swings in the economy and markets; low correlation of returns with other asset classes; long term, stable and predictable cash flows; good inflation hedge; low default rates)*
- *regulatory regime, contractual approach (regulated asset base, concession, licensed); specific contractual arrangements (project finance, PPP)*
- *combinations and variations of the above*"

Source: Inderst 2013

Figure 3 investigates the need for infrastructure investment in Europe. On Panel A, we can observe the different types of infrastructure investment that are needed from 2013 to 2030 based on different projections (historically-based, GDP-based and external estimates). The graph highlights what types of assets are the most represented in what we refer to as "infrastructure". More specifically, one can observe that roads, power, water and telecom represent the biggest part of investment needs, while rail, ports and airports are less important. The total estimated amount needed for infrastructure investment ranges between 57 and 67 trillion US dollars but do not focus on Europe only and accounts for the 84 largest countries in the world. According to the OECD, if adding up the investment needs for energy generation, other energy-related infrastructure, as well as oil and gas transport, is raising the estimate to US$ 67 trillion between 2013 and 2030[2], equivalent to an annual average investment needs of **US$ 8.4 trillion per year**. Estimates for the EU exclude water & sewage, waste management, social infrastructure and power generation and are about €150 to 200 billion for Europe and £50 billion for the UK, as illustrated in Table 1. Interestingly, Table 1 further indicates that **in Europe, energy will require over half of the investments.**

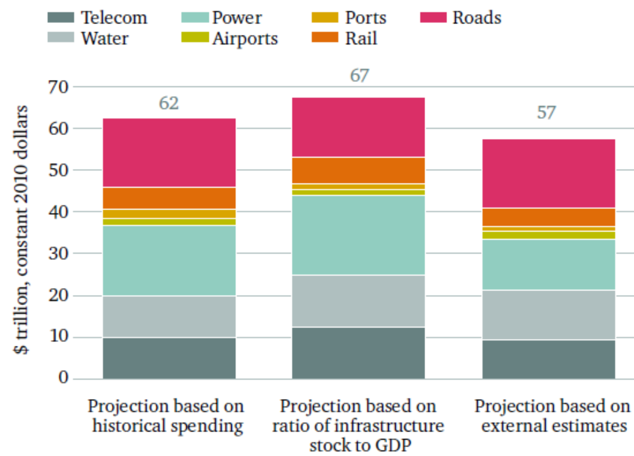
Investment needs require financing. It is difficult to find estimates of the infrastructure financing gaps. One attempt is proposed by the WEF (2012), estimating a **global financing gap of about US$ 1 trillion per year** (1.25% GDP), as well as a '*green infrastructure investment gap*' of US$700 billion (WEF, 2013). Figure 4 gives a picture of how typical infrastructure projects are funded in Europe. Interestingly, most of these projects are financed by loans, and new issuances in Europe's bond markets for infrastructure projects almost completely disappeared after the crisis.

In sum, the need for infrastructure investment is well identified although what is referred to as 'infrastructure' may vary depending on its context. It represents significant amounts, and mostly relies on banks.

[2] OECD estimates were computed on the 2013-2030 period, we here apply a prorata to get the equivalent estimate on the 2013-2030 period

Figure 3: Estimation of infrastructure investments needed in the world's 84 largest countries from 2013 to 2030

($ trillion, constant 2010 dollars)



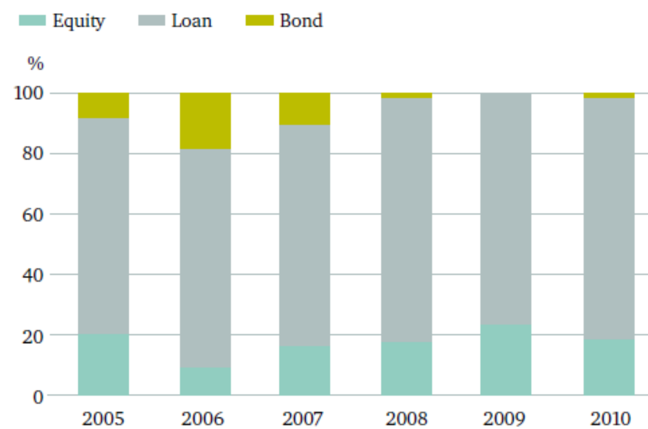
Source*: Chatham house, 2014; McKinsey Global Institute, 2013*

Table 1: EU and UK infrastructure investment needs from 2011 to 2020

	EU € trillion	UK £ trillion
Transport	0.500	0.120
Energy	1.100	0.264
Telecom	0.268	0.005
Water	NA	0.045
Total	1.500-2.000	0.500
Annual Average	1.5	0.050

Source: *EIB, 2013; EC, 2011 for the EU; Helm et al., 2009 for the UK*

Figure 4: Financing infrastructure projects in Europe
(old member states[3])



***Source**: Chatham House, 2014; Inderst, 2013*

Investment in SMEs

Another important asset class that enables economic growth is SMEs. The SME market indeed play a major role in our economy. As reflected by the figures below, the not only represent a very big part of corporates, but they also help reduce unemployment and significantly create value. They are also mainly financed by banks. As indicated below, 80% of SME financing indeed relies on commercial banks.

> ***SMEs** represent **99%** of businesses, **2** in every **3** employees, **58** cents in every euro of value added*
>
> *(European Commission, 2014a)*
>
> ***80%** of their total financing rely on commercial banks*
>
> *(Ernst and Young, 2014)*

2. Why is there a problem?

The supply of long term loans by banks

As we saw in the previous section, improving economic growth requires to increase investments in the assets that foster long term economic growth. Two important types of long term investments are infrastructure projects and investment in SMEs. As explained, both types of assets largely rely on banks for their funding.

[3] i.e. the 15 countries that were members of the EU prior to the accession of 10 new member states in 2004

One problem is that, in the wake of the financial crisis, banks had to repair their balance-sheets. Many banks suffered important losses from collapsing mortgage markets, complex securitization products or sovereign risks. Restoring their solvency was difficult as investors were reluctant to put more money in the banking sector and profitability was low.

The other problem is that the new regulatory framework increased significantly the capital requirements and pushed banks to become less risky. Traditional activities such as the transformation of short term deposits into long term loans were restricted by the new liquidity rules. As emphasized in Chatham House (2014), the Basel III rules steered banks away from the long-term loans required by backers of infrastructure projects. Despite the low interest rates and the massive liquidity provided by Central Banks, the supply of long term loans remained subdued because of solvency and regulatory problems in the banking sector (see Box 1).

Box 1:

Why Basel III has a negative impact on the attractiveness of LT finance for banks

Basel III introduces three changes that will have an impact on long-term finance:

(1) Banks need to hold a higher percentage of Tier 1 capital and are imposed additional charges for risk (exposures to financial institutions, derivative transactions)
(2) Banks have to meet both short-term and longer-term liquidity ratios (LCR and NSFR)
(3) Banks must deleverage (new gross leverage ratio)

This new regulatory framework will lead to

(1) An increase in the cost of LT capital for the banks
(2) A significant reduction in the length of loan maturity

Source: BNP Paribas Corporate and Investment Banking

According to Wehinger (2012), the deleveraging estimate necessary for European banks alone is $2.6 trillion i.e. 7% of their assets, with 25% of that coming from lower lending and 75% from asset sales or profit retention.

Can other financial institutions replace the role of long term funding from banks?

Insurance companies

A recent Vlerick study (Thibeault and Wambeke, 2014) argues that while on the one hand Basel III indeed favours investments with shorter maturity, on the other hand Solvency II directs insurers towards long-term fixed income investments, as they have also long term liabilities. As a consequence, insurers can benefit from regulatory arbitrage opportunities compared to banks.

For example, the authors find that insurers have a clear regulatory advantage over banks for residential mortgage loans with long maturity and low loan-to-value ratio. For other long-term loans such as infrastructure loans, long-term export and long-term loans to public entities, Solvency II also appear as advantageous compared to Basel III.

From these findings, two messages are key. First, one can reasonably expect that Basel III will reduce the ability of banks on long-term lending. Second, this represents opportunities for other

players on the market for LT finance, such as insurers. The insurance sector also has its new regulatory framework but Solvency II actually appears to provide better incentives for LT finance to insurers than Basel III to banks.

However, while solvency II seems to be less negative for long term investments than Basel III, it is still a very risk sensitive and "fair value" oriented regulatory framework, which means that also the insurance sector is pushed towards less risks and more liquidity as the European Commission is well aware in its comments about Solvency II: "Further work is needed to identify lower-risk infrastructure debt and/or equity investments, with a view to a possible review of prudential rules…" (European Commission, 2015b, p17)

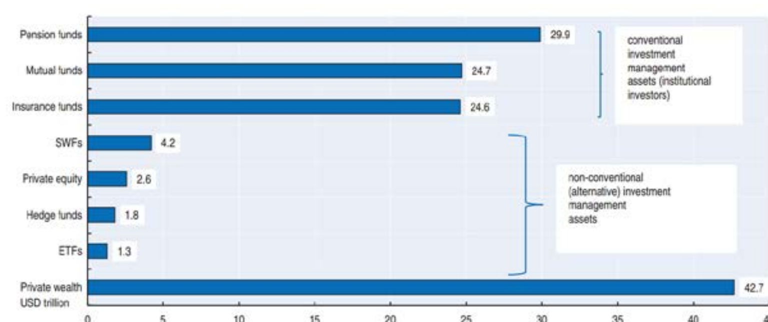
Furthermore, most insurance companies still miss the expertise of lending to SME's, which is up till now almost a monopoly of banks. Building this expertise or developing structural cooperation with banks will take a lot of time.

As a consequence, it seems unlikely that insurance companies will be able to replace the banks in providing long term funding to the economy.

Institutional investors in general

Figure 5: Institutional investors and alternative asset managers

2010 Global Fund Management Industry, Assets Under Management (AUM)



Source: *Wehinger (OECD 2012), TheCityUK estimates*

As we can see from Figure 5, insurance companies and pension funds are major players in terms of assets under management. There are hopes that pension funds and insurers could replace banks in long-term syndicated loans to some extent. However, as argued by Wehinger (OECD 2012) they would not be able to fill the lending gap left by banks. There are indeed some investment barriers to insurers and pension funds as well, including macro-economic, political and regulatory barriers.

On Figure 5, we observe that hedge funds and private equity respectively held $1.8 and $2.6 trillion of assets worldwide in 2010. Their role in closing the lending gap can therefore only be relatively small, given the size of the problem.

One may argue that given the lack of ability to fill the lending gap left by banks, other non-bank entities are needed. For example in the US, money market funds have $1.6 trillion of assets of which 30% are commercial and corporate paper. S&P (2013) estimated that US$ 20 billion of alternative debt finance came from the 'shadow banking' sector in 2012, and this amount was expected to rise to US$ 25 billion in 2013. Société Générale (2013) argues that a market for

private bonds and loans would develop in Europe, with energy and transport as attractive sectors for investors. But these alternative players are not more likely to fill the entire lending gap.

3. What are the European initiatives to provide more long term funding to the economy?

In March 2013, the European Commission opened a public consultation on the long-term financing of the European economy. A year later, the Commission proposed a set of actions focusing on (i) mobilising private sources of long-term financing, (ii) making better use of public funding, (iii) developing European capital markets, (iv) improving SMEs' access to financing, (v) attracting private finance to infrastructure delivering Europe 2020, and (vi) enhancing the wider framework for sustainable finance. The related initiatives are summarized hereafter.

The "Juncker's plan"

What?
315 billion euros will be mobilised on the 2015-2018 period for a major investment plan at the EU level. The plan goes hand-in-hand with targeted initiatives to ensure that the invested money meets the needs of the real economy, and with efforts to improve the investment environment in Europe. A new European Fund for Strategic Investments will be established to support long-term investments and increased access to finance for SMEs.

When?
In November 2014, the European Commission and the European Investment Bank (EIB) proposed the Investment Plan for Europe (EC 2014b). The European Fund for Strategic Investments should be in force by June 2015.

The Capital Markets Union (CMU)

What?
CMU was launched by the Commission to boost jobs and growth in the EU28 by reducing fragmentation in financial markets and improve access to finance for businesses, particularly SMEs. Its creation is a key element of the Juncker's Investment Plan announced in November 2014. The goal is to build stronger capital markets to complement banks as a source of financing for Europe's businesses, and particularly SMEs. While the Commission is aware that building such a union will be a long process, it also identifies a number of projects on which short term progress seems possible. The content of the CMU is partly new, and partly an overview of initiatives which have been launched earlier.

When?
In February 2015, the Commission launched a 3-month public consultation on possible measures which could be taken to achieve a Capital Markets Union. As mentioned in the Commission's Green Paper (2015b) this is a long-term project over many years. The Commission aims at putting in place the building blocks for a fully functioning Capital Markets Union by 2019.

The European Long-Term Investment Funds (ELTIFs)

What?
This new type of fund is offered to EU investors willing to commit money over long periods into illiquid assets. The purpose of its creation is to boost finance available to companies in search for long-term capital. To be qualified as an ELTIF, funds have to invest in unlisted companies needing long-term capital (including for infrastructure investment and SMEs) and at least 70% of the money in the fund has to be invested in these assets. As any investment product, ELTIFs also fall into the MiFID requirements. Despite the higher risk profile of ELTIFs, given the restricted liquidity, these funds would, under specific conditions, be available for retail investors.

When?
In March 2015, the European Parliament has reached agreement on the framework on European Long Term Investment Funds (ELTIF) proposed by the commission in June 2013 (EC 2013). The regulation was adopted by the council in April 2015.

A framework for high-quality securitisation

What?
High-quality securitisation is an important short term priority of the CMU. The Commission (EC 2015c) claimed its conviction that securitisation is a crucial element of well-functioning financial markets, enabling diversification of funding sources and allocating risk more efficiently within the EU financial system. The related initiatives complement some work of the European Banking Authority (EBA), the European Central Bank (ECB) and the Bank of England (BoE) which are also active in ensuring higher standards for new securitised products.

When?
The ECB and the BoE had launched a consultation on the securitisation market in Europe in May 2014. In October 2014 and February 2015, the EBA and the European Commission launched a public consultation on simple, transparent and standardised securitisations and their potential regulatory recognition.

A revision of the Prospectus Directive

What?
The Commission is now revising its prospectus directives laying down the rules governing the prospectus required when a company issues securities in the EU. The current requirements indeed create barriers to accessing capital markets, and the Commission wants to reduce these barriers and make it easier for SMEs to raise capital.

When?
In February 2015, the European Commission launched a public consultation on the review of the Prospectus directive. This consultation is part of the Commission's Regulatory Fitness and Performance programme (REFIT) whose related actions are planned to be implemented during 2015.

Improving SME credit information

What?
In its consultation paper on the CMU (2015b), the European Commission highlighted the necessity to improve credit information on SMEs. The Commission intends to create standardised credit quality information in order to help the development of financial instruments to refinance SME loans, such as SME securitisation.

When?
The project is still at a very early stage but the Commission indicates that the work on SME credit scoring has already started and received support from the Member States. The Commission is now planning to hold workshops on SME credit information in 2015.

4. Will these initiatives be successful and sufficient?

There is general support for a regulatory effort towards a facilitation of long-term finance instruments in the European Union as the actual lack of long term finance is a threat for the recovery of the European economy. The broad project of creating a Capital Markets Union is ambitious and will take a long time, as the whole environment has to be adapted to such Union: market infrastructures, tax regimes and culture. Meanwhile trying to realize a number of limited projects can only be welcomed, as long as they fit within a coherent plan to build a stronger European economy.

In getting to that coherence, a number of specific issues require attention.

Growing regulatory costs for banks

Among the diverging arguments against the efficiency of the regulatory initiatives on long-term finance, there is a view that the growing regulatory cost constitutes a serious threat for banks, especially the smaller ones. As it will take a lot of time to build a full European Capital Market, banks should be able to provide as much as possible long term funding. Any further regulatory burden will increase the problem. Especially the discussion about structural reform of banks is important, and more specifically the debate about Market Making. Banks are the major providers of Market Making in secondary debt markets. If this activity is no longer acceptable because of the compulsory split between the “core bank” and the “trading bank”, it could further undermine the growth of financial markets.

High quality securitisation under debate

The design of a framework for high quality securitisation is still at an early stage and the related regulatory features are still vague. There is a high uncertainty on what would be the appropriate regulatory framework as notably reflected in the debates of the Finance Watch conference in February 2015. The use of the ‘high quality’ terminology is questioned as it could divert investors from their duty to carry out their own due diligence. The practice of tranching is also under debate (i.e. splitting securities into different classes with different credit ratings). From one view, this practice should not feature in the framework because it creates uncertainty, introduces complex risks, procyclicality, and conflicts of interest. Another vision is that tranching is desirable, since it is already a widely used technique in bank financing, for both equity and debt issuances. A more nuanced view is that tranching is only suitable for certain kinds of investors holding the right kind of risk and liquidity appetite.

Coherence needed in the European approach

If the European Union wants to increase capital markets in order to reduce the weight of banks on providing long term funding to the economy, it should develop a coherent plan to develop more capital market activities. The EU should be careful not to send opposite signals to the market operators, such as a Financial Transaction Tax.

Also some elements of MIFID II such as the liquidity rules, could be a further burden for market developments.

The need for a coherent vision on risk tolerance of society

Without any doubt, long term finance requires more risk taking. Someone needs to be willing to take this risk. Banks were traditionally fulfilling that role, but are not able and/or willing to continue as in the past. Also insurance companies and pension funds have to be more risk sensitive. But at the same time, private investors have to be protected against any risk, and any financial advice about "risky" assets as investment opportunities are increasingly suspect and dangerous in the framework of increasingly intrusive consumer and investor protection rules. Meanwhile, governments have already excessive debts and cannot take over the natural risks of long term investments.

There is a need for a coherent policy in the EU about the problem of low risk tolerance which undermines long term finance and other drivers of economic growth.

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REPORT OF THE 3RD VLERICK REGULATORY WORKSHOP

This section summarizes the presentations and discussions of the 3rd Vlerick Regulatory Workshop which took place on June 24th, 2015 at Vlerick Business School in Brussels. The topic of this 3rd workshop was: **LONG-TERM FINANCE: CHALLENGES AND OPPORTUNITIES IN THE FINANCIAL SECTOR.**

19 experts were present from different horizons: regulators , lawyers, bankers, insurers and Academia , which allowed to tackle the subject from different angles.

The workshop was organized as follows. In a first part, Martin Koch (European Commission) presented a description of the regulatory instruments used to stimulate long-term finance. In a second part, Professor André Thibeault presented the impact of the regulatory changes on banks' and insurers' investment policies. The third part was dedicated to long-term finance in practice by insurers and banks, with one presentation by Wim Vermeir (AG Insurance and Ageas) and one by Johan Vankelecom (Belfius). Each part was followed by a discussion with the audience.

Regulatory instruments to stimulate long-term finance

Martin Koch, European Commission, Directorate General for Financial Stability, Financial Services and Capital Markets Union.

Since the financial crisis of 2008, there is a growing investment gap in many member states of the European Union (EU) and also a lack of competiveness, leading to relatively low growth of the GDP. A full recovery to pre-crisis levels is hindered by a complex environment:

- Risk appetite of banks and insurers is limited given the new regulatory requirements (Basel III and Solvency II)
- Existence of financial and non-financial barriers to investments; on-going market fragmentation in the EU
- Governments are confronted with excessive debt levels, which limits their spending potential
- Extremely loose monetary policy with very low interest rates and abundant liquidity provided by central banks does not have the expected positive effects on growth.

Some studies estimate that EU long-term investment needs are up to EUR 1,000 billion for infrastructure in transport, energy and telecommunication. Additionally EUR 1,000 billion is needed for investments in "classic" infrastructure of water and sanitation. On top of that, also corporates, especially SME's and Midcaps need to invest more in growth and innovation.

Thus the key challenge is how to mobilize the available liquidity in the market for financing long term investment projects. The EU is promoting several initiatives to stimulate long-term investments financing:

- Increase the availability of long term funding by using the EU budget as a catalyst and risk buffer. In order to increase long term funding, the Juncker plan aims at mobilizing 315 billion during the next 3 years, in order to provide funding for infrastructure (240 billion) and SME's (75 billion).

- Create a Capital Market Union (CMU) since the EU market is actually under developed and fragmented along national borders, due to regulatory and technical hurdles. The CMU also aims in general at increasing non-banking finance. After the CMU consultation, the EU Commission is preparing an action plan. The CMU Action Plan might include some legislative

measures but has not the ambition to create a completely new regulatory framework. It is about how the market can fix itself and stimulating it for allocating capital to long term investments. For that purpose, the EU Commission is now working on different short term priorities such as:

- A review of the prospectus directive in order to lower the administrative barriers to accessing capital markets,
- Improve credit information about SMEs,
- Create a simple and transparent "high-quality" framework for securitization as an important instrument for transferring risk to the market,
- Develop an EU private placement market,
- Promote the use of European Long-Term Investment Funds (ELTIFs).The ELTIF regulation is directly applicable to all EU member states, excluding any goldplating by member states. ELTIF is a new type of investment fund which can only be managed by fund managers authorised under the existing Alternative Investment Funds Directive (AIFD). ELTIFs must invest in long term real assets like infrastructure or undertakings. Typical investors in ELTIFs would be pension funds and insurers but also, to a certain degree, retail investors. ELTIFs should provide stable long-term returns and diversification of risks.

The Commission is well aware that in the end, the market will decide: if investors don't see the benefits of these initiatives, they will not be successful in practice.

Discussion

The presentation of Martin Koch was followed by a discussion.

A concern was raised that long term projects could be important for the European Union as a source of growth but not necessarily interesting from a private investor's point of view given its risk/return characteristics. In order to stimulate investment in long-term projects and promote projects that investors could rely on, the allocation of risk during the project's life must be well monitored. The ELTIF regulation intends to create a framework where an investor can participate in an optimal and diversified way, taking into account risk and return.

The intention of the CMU is to diversify sources of finance for the economy and, in addition to traditional financial intermediation through banks, offer more market intermediation and alternative sources of finance to companies and investors,. However there is a concern that there will not be a level playing field between banks and non-banks on the market, given the lighter regulatory regime for non-banks.

The demand for funding long-term projects was finally evoked. Who will take the risk to launch a long term project if the European Economic Area is in crisis and with a difficult macroeconomic situation? Is the expected growth of below 2% enough to convince entrepreneurs, companies and organizations to start long-term projects? Moreover, public debt constrains in EU States do not allow the public sector to launch many of the needed projects. The fact that interest rate spreads are very low on good quality long term projects is an indication that the problem is not that much about access to finance, but about finding feasible projects.

The regulatory impact on banks' and insurers' investment

André Thibeault, Professor of Banking & Financial Markets, Vlerick Business School

The challenge in the public sector at global level is to cover a need of 57,000 billion dollars in public infrastructure projects from 2013 to 2030 and attract financing for covering this gap. Given

the fact that there is money in the market, the big question for private investors is where to find decent returns.

For his analysis Professor Thibeault assumed that there are only two worlds in the economy: 1. the real sector having the surplus unit and the deficit unit, and 2. the financial sector. Therefore in the assessment of every project the private potential investors will check its return compared with its cost of capital. In the financial sector long-term investors, mainly banks and insurance companies will look for decent returns for their shareholders. These returns (ROE) come from two sources: operational profitability (ROA) and leverage. However, the last one is highly regulated and oriented to reduce solvency risk. So, the challenge is to improve operational profitability.

Based on the analysis of Accenture, McKinsey and Morgan Stanley, Professor Thibeault presented the impact of the regulations Basel III and Solvency II in financial companies.

First, Basel III impacted negatively the ROE of banks in different ways such as higher cost of funding, reduced fee income, higher capital ratio and NPL provision increase. Some mitigation actions from banks are possible, such as business model adjustments, balance-sheet restructuring and the development of additional activities which generate additional income.

Second, Solvency II impacts the ROE of insurance companies through its impact on capital requirements, underwriting practices, asset allocation and the mix of assets and liabilities (ALM). According to Morgan Stanley, the Non-Life companies will register the greatest reduction into their solvency ratio and, subsequently, a negative impact in its ROE. Therefore, the best way to try to offset the negative impact of Solvency II is to diversify.

As Solvency Capital Requirements (SCR) increase, there are two ways to compensate: 1. increasing prices and 2. reducing cost. Otherwise there is a risk of being out of the market.

According to a survey conducted by Vlerick Business School and KPMG, the CEOs of the banks in Belgium agree that a way for maintaining the ROE is to increase operational profitability because the leverage is going down due to regulation. Cutting staff costs is a common answer between the interviewed executives. None of them referred to a new business model or innovations. In other words there was no reference to improve profitability from the income side.

Other points of pressure in the economy are SMEs and Public Private Partnerships (PPP). First, SMEs constitute an important driver of the economy's growth and represent more than half of the EU market in terms of employment. Improving securitisation of SME loans is a way to give indirect access to the capital market. Regarding the issuance in securitisation, a peak is registered during 2008 but this trend is going down because of the change in regulation. Banks and insurance companies don't have incentives for securitizing SME loans .

In the case of investments using PPPs, the amounts in developed countries are quite flat over the time. However in the emerging economies they are expending as a main form to finance the public sector. After the crisis in Europe, the deal flow of PPPs has come down significantly. Despite a recent increase, it is still not at the level of before the crisis.

As a conclusion Prof Thibeault referred to the two keys to success for financial companies:

1. Redesign their business model. Financial companies need to think about how to generate more income from redesigning their balance and off-balance sheet.

2. Improve their operational efficiency so that banks and insurance companies can continue to finance the economy.

Discussion

The first question raised by the audience was about the cost of equity of banks and insurance companies after the crisis. Professor Thibeault answered that, due to the volatility, the cost of equity went up substantially but is now coming back. But, for banks and insurance companies, the damage that the volatility has generated is an impediment to raise their stock prices. Also the new regulation has a negative impact on stock prices.

The audience shared comments about the evolution of the cost of equity given the regulations. Since the capital requirements forced the banks to increase capital in their balance sheets, the cost of equity should in theory be going down.

The redesign of the business model in banks and insurance companies is happening. However, the need to convince the clients and then to redesign the model in a MiFID compliant way makes it very difficult.

A view from the insurance sector

Wim Vermeir, CIO (AG insurance & Head of investments Ageas)

The insurance industry is the world's largest institutional investor with a 50% market share. They invest premiums received from protection, investment and pension products. In their investment strategy, the insurance companies take into consideration long-term scenarios, the risk-return characteristics of assets, the risk appetite and the regulatory framework which is getting more important.

The actual low interest rate is not a problem for their existing portfolio for thoise insurers that have well managed their ALM risks, but even for them, it is challenging for new production.

The regulatory framework is challenging for the insurance industry. The current regulations are becoming more market-to-market. For instance, due to the upcoming accounting regulation IFRS 9, every price movement of the investment in equity by insurance companies has to be registered in their P&L.

The general framework of Solvency II is inspired by Basel III. The risk charges are linked to the volatility.

Solvency II is a big step forward as it is risk based and not volume based like Solvency I. However it is only based on a 1 year horizon, which is not in line with the long term horizon of life insurance. The Mark to market mechanism in Solvency II is pro-cyclical as it encourages risk taking when risk premiums are low.

The portfolio of AG Insurance is composed mainly by government bonds (62.5%), corporates, direct loans and a small allocation to equity because of Solvency II. This small allocation is compensated by Real Estate with lower capital surcharge and its less volatile characteristic.

Ageas has appetite for infrastructure loans because they have long duration that matches with the long duration of insurance companies' liabilities. They also offer a source of diversification, constitute a good alternative to government bonds and their recovery rates are high.

The problem is that the governments are not initiating enough infrastructure projects given their budgetary constrains

In the capital charge model (Solvency II) the rate takes into account a one year horizon. For insurance companies however, the investment horizon is long and the underlying risk is the ultimate credit loss. The Solvency treatment here is not aligned with the specific characteristics of infrastructure projects with low long term risks. Fortunately, there are some initiatives of the EU Commission in order to align regulations with the economic perspective.

Some barriers to infrastructure investments were identified. As is already mentioned, Solvency 2 is not sufficiently supportive to the investments in that sector. There are also other regulatory and tax barriers that limit access to projects of other countries. Also financing structures are not adapted to the needs of institutional investors. Public authorities are reluctant to offer clauses which protect insurance companies against early repayment risk. And of course the risk-return profile should be attractive.

AG Insurance is ready for investing in long term assets but the regulation that is focused on short term volatility is pointing in another direction.

Discussion

The volume of long term projects remains too low in the EU, but this can as well be a result of low demand or of low supply of funds. In the current context, the spreads are too low on long term infrastructure financing to make them attractive for institutional investors. The long term funding is available but there are not enough profitable projects. One reason could be related to the current economic environment and the public debt constrains, jointly with the fact that no matter how cheap it is to launch projects there are no projects at economically justifiable prices. There are available funds in the market but no demand and a very low spread. Maybe once quantitative easing would be over, this spread could rise and attract more investors to long-term projects.

A view from the banking sector

Johan Vankelecom (CFO, Belfius)

The question is about how to strike a balance between supply and demand. That is the key point of the debate. That balance is since the crisis, and still today, from the point of view of banks, disturbed by 3 elements related to 1. asset and liability management, 2. regulation and 3. economic environment (low demand).

The speaker agrees with the fact that there is enough liquidity coming from the insurance companies and banks for covering the supply side but there is not enough profitable demand in terms of economic expansion that allow investors to have confidence in long term projects. In general, many corporates for instance use their own cash for short term projects and not for generating value in long term projects.

Related to the first constraint, the medium term funding of the banks mainly comes from the saving accounts (medium term funding). The role of the bank is maturity transformation in order to generate additional income and to increase supply of long term finance. On the asset side, the banks have long term fix rate loans such as mortgage loans or infrastructure loans.

This maturity mismatch creates interest rate risk besides liquidity risk and credit risk. Banks hedge interest rate risks using derivative products but liquidity risk cannot be hedged as clients (corporate and individuals) are not interested in putting their money in the bank's balance sheet for twenty years because they prefer liquidity. Also credit risks cannot be fully hedged. Both types of risks have to be managed. The board of directors defines the risk appetite, but also the regulatory framework imposes limitations on risk taking such as Liquidity guidelines, solvency ratios and credit limits.

What happens if after granting a loan the interest rate comes down like we have seen the last years? Even if interest rate risks are fully hedged with derivative positions, there are still some effects in the bank's balance sheet such as for example the need for more collateral. Credit risks also increase because the value of the long term fixed rate loan that bank granted has risen above par, which means that if the project / borrower is defaulting, banks risk losing more than the nominal value of the loan.

Long term financing was always challenging but the financial crisis created much bigger awareness on liquidity risk and a general consensus that more regulation was needed in order to avoid future bail-outs with public finances. The regulators' first task is to protect the deposit holders in all cases, especially retail deposit holders.

As a second constraint, the new bank regulation Basel III is very challenging for banks' management since there are uncertain aspects about the level required, when it will be required and in what type of capital. Basel III imposes a stricter Common Equity Tier 1 Ratio, a minimum leverage ratio independently of the risk profile of the assets, and stricter liquidity rules. Some consequences of Basel III are:

- More capital than before is needed for the same economical risk.
- Assets like long term projects with relatively lower margin/lower default risk become much more expensive to carry/fund than before.
- Long-term illiquid loans are clearly less attractive from liquidity point of view.

As a summary, the situation of long term finance in Europe can be described as follows:

- The economy in Europe is performing below potential. There is a competitive disadvantage of Europe, also coming from higher labour costs. This leads to subdued demand for long term project financing.
- Public budgets should promote infrastructure financing. However, increased Budget discipline under the form of the ESA 2010 norms reduces room for government investments.
- There is a need to reduce systematic risks in EU with a view to increase the protection of deposit-holders and state's finances but that has materially increased the cost of funding long term loans (equity and debt).
- Hence, currently there is clearly no balance between offer and demand. Offer is there, but at pricing that is to be interesting from investor point of view (which could still be a bit more expensive than before the crisis), mainly due to stricter regulations on banks and insurers. Demand is not really there, since projects/borrowers are too uncertain about EU economic growth prospects and public finances are under severe budgetary discipline constraints.

Discussion

During the discussion, it was evoked that there are many initiatives for incentivizing the demand of projects coming to the market (e.g. the Juncker's Plan). The solution could be to generate other financing sources apart from the banks.

The question for the panel of experts was: what can be done from each party on the market to stimulate long-term finance?

Martin Koch believes that the low interest environment will not last forever and it is an extraordinary effect due to the market situation. There is a need to reinforce infrastructure or to invest in new projects. At a certain point those needs will materialize in concrete projects. The Juncker's List is a starting point to get a total view of projects and look their financing needs in a structured way.

From the investors' side, Johan Vankelecom recognizes that there are interesting projects in terms of risk – return. But from the demand side those have to be backed up by the States. The fact that Belfius has a Bank and an Insurance company helped during the crisis because of the different maturity profiles of their respective balance sheets. Another action established by banks was to redesign their business model to generate different income from different sources. In long term financing, the problem in Belgium is not the price, it is demand.

From the insurance industry, Wim Vermeir agrees with the idea that low interest environment is temporary. He expected that when the quantitative easing would be over, the rates could normalise. He considers that there is a current regulation mismatch. For their investment strategy, AG Insurance assesses what is available in the market and then looks for a good risk – return combination.

From the Academia, Prof Thibeault pointed out that there is plenty of liquidity in the market but it seems there is an important misalignment between the economic policy agenda and regulatory environment. For example, even in the case of a low risk project, the capital consumption is still very high.