

**Long Term Investment and Reindustrialisation
Intergroup
Restarting investment growth in Europe
Brussels 28 June 2016**

I - Some facts : Corporate investment and productivity gains are much higher in the US than in Germany or in the Eurozone

A. Total productive investment (volume as % of GDP)

2015	US =	12,5%
	Germany=	10%
2007	US =	12%
	Germany=	10%
2000	US =	11%
	Germany =	10%

From 1998 to 2015 in cumulative terms, US productive investment has been 20 points higher in terms of GDP than in Germany.

B. Productivity gains are much higher in the US than in the Eurozone

Between 2000 and 2014, productivity grew by 10,7% in the US but only by 1,4% in the euro area.

Calculated per capita, productivity gains are much higher in the US than in Germany.

1998 =	100
US 2015 =	140
Germany 2015 =	110

C. Corporate debt is significantly higher in Europe than in the US

US =	40% of GDP (nominal terms)
France =	70%
Germany =	80%

D. R&D is higher in the US (3% of GDP) than in the euro area which has the target to reach 3% in EU 2020 target

II - Why is it so?

A. Enterprises are freer to work and make profits in the US than in Europe

- Less regulation and more flexible markets: many European countries impose administrative burdens on creating new firms or on growing beyond arbitrary thresholds that trigger increase in compliance costs. This is not observed in the United States.
- Working hours are less in Europe than in the United States
- Fiscal and social contributions are higher in Europe

B. In spite of more buoyant savings in Europe, financial markets are three times more important in the US than in the EU in financing the economy.

European equity markets are much less developed than in the US. ¹

European enterprises rely on banks for almost $\frac{3}{4}$ of their financing ($\frac{1}{4}$ in the US).

Therefore, in the wake of the financial crisis which has been followed by a doubling of capital requirements for banks, such a huge recapitalisation effort is bound to have a more significant impact on the European economy than on the US.

This is manifest in the reduction in outstanding bank credit to non financial corporations that has been observed over the last three years.

¹ Equity financing of US non financial enterprises amounts to 93% of GDP against 34% in the Eurozone.

III - A massive need for infrastructure investment in Europe

A. Total needs

The amount of infrastructure investment (transport, energy, telecommunications, water, health, education, electricity) in Europe is estimated at 650 Billion € per annum until 2020.

B. The stakes

Infrastructure investment is a precondition for long term growth.

According to IMF calculations, an additional infrastructure investment of 1% of GDP would result in a permanent increase of 2% of GDP.

C. The Juncker Plan

The “investment plan for Europe” would help reduce the deficit in investment that has accumulated in the EU over the last 10 years :

21 billion € of public funds are intended to leverage 315 Billion of private financing (2015-2018).

These 315 Billion will be invested in debt, equity and quasi equity instruments, in infrastructure projects (240 billion) and SMEs (75 Billion).

IV - What to do?

Given the above analysis, two lines of actions seem obvious:

A. Structural reforms

- ✓ Reducing public expenditures especially when they represent too large a proportion of GDP (France 57%, Italy 52% versus 43% in Germany and 42% in Spain); cuts should be focused on current non-productive expenses and not on useful public investments
- ✓ Increasing employment (as a % of population between 15 to 64, Germany counts 72% employed people, France = 64%, Italy= 56%...) as well as reforming pensions systems taking into account population ageing

Increasing employment depends very much on decentralised and flexible labour negotiations and on an effective training system

- ✓ Reducing regulatory barriers to entry on new enterprises and increasing competition

All these points should contribute to Increasing operative margins specially for SMEs (Germany= 43% of Gross Operating Income as a percentage of Value added; France = 29%, average Europe 38%).

B. Financial markets reforms

We have to understand that national savings – which are high in Europe – are **the** only resource available to finance long term investment.

The financial assets of households have massively increased over the last 15 years (in France, for example, those financial assets represented 4,2 trillions € in 2014 against 2,5 in 2000).

But these assets are mostly invested in banking accounts (with tax exemptions), in life insurance products and in collectively managed investment. The direct holdings of equity shares and bonds are very limited². So the challenge is to channel more of these savings into long term investment products. This is not easy because of different obstacles :

² In the US, shares held by households represent 70% of GDP. In the Euro area, the figure is 8%.

- ✓ Households in Europe are risk adverse and are not inclined to hold long term investment products like equity or long term private debt investments ;
- ✓ The banking system – which collects a large part of household savings in the form of savings accounts – is not in a position to easily transform these liquid savings into long term assets : regulation (Basel – NSFR) penalizes such a maturity transformation ;
- ✓ Regulation has reduced the profitability of banks by increasing capital requirements and imposing large amounts of liquid assets that yield no return in our 0 interest rate environment.

There is no doubt that the Basel III regulation is deterring banks from holding long term investment instruments. The result is a shortening of the time horizon of banking assets.

- ✓ Insurance companies – which used to be significant buyers of equity in Europe and played an equilibrating role on financial markets – are now dissuaded from holding equity instruments on their books.

V - Specific proposals to encourage long term investment in Europe

There are different ways to get out of these straights :

A. One is to establish a special – favourable – prudential regime for long term infrastructure investments.

There has been some progress in this field but the obstacles are not all removed (explain....).

The creation of an Infrastructure asset class is a breakthrough.

Based on the evidence regarding the lower level of default and high rate of recovery of infrastructure financings, Eurofi has advocated the creation of an infrastructure asset class which acknowledges all its specificities.

This all the more important since European savers need long term and predictable assets notably to finance their pensions/retirements. These needs are reflected by insurer and pension funds long term liabilities, which have to be matched with such long term assets.

Some significant openings have been recently achieved in this field

On 30 September 2015, as part of a package of measures forming part of the Capital Markets Union initiative to remove barriers to investment in the EU, the Commission made a number of amendments to the Solvency II Delegated Regulation.

'Qualifying infrastructure investments' will form a distinct asset category under Solvency II and will benefit from an appropriate risk calibration, lower than that which would otherwise apply. This will ultimately lead to a lower capital charge.

For example all “qualifying infrastructure equity investments” will now have a risk calibration of 30% of their value, compared to 49% for unlisted equities, into which category most infrastructure project equities fall; equities traded on regulated markets and MTFs (multilateral trading facilities) have a risk calibration of 39%.

The capital charge related to qualifying infrastructure investments in the form of bonds or loans has also been significantly reduced for various maturities and credit quality steps.

In addition, insurance companies, which do not have the in house capacity to fulfill all the due diligence requirements, will enhance their long term investment capacity as far as this delegated act also allows investments in European Long-Term Investment Funds (ELTIFs) to benefit from lower capital charges under Solvency II.

However capital charges still outweigh the risks fostered by investing in infrastructure.

Indeed, insurers are still unduly considered as traders. Therefore, the risks of infrastructure assets are assessed through the market risk module of Solvency 2.

In my view, such assets should be addressed through the counterparty risk module since insurers are actually exposed to credit default and level of recoveries. Indeed, insurers have the ability to avoid forced sales as these assets are matched with long term liabilities. Furthermore, infrastructure assets are not traded in financial markets since they are illiquid and have no market price.

The consequence of this economic misjudgement is that infrastructure risks are actually priced at least twice what should be, which divides by 2 the ability of EU insurers to invest in long term assets.

In addition, infrastructure assets, which are, by essence, “through the cycle investments”, are inappropriately correlated within the regulatory risk assessment approach between 75 and 100% with corporate securities. Consequently, this means that the EU regulator considers that infrastructure assets do not provide any diversification benefit to insurers.

B. It would also make sense to facilitate securitization.

Indeed the transition towards a more financial model in Europe will take time and must be organised given the heavy burdens on banks’ capital requirements, Securitisation gives the means to transfer to investors large segments of bank loans portfolios.

This should not only concern real estate and consumer credits but also more critically, SMEs.

Unfortunately, this relaunching is not happening

Two critical checks are required to achieve a sound EU securitisation market : the Simple and Transparent and Standardised (STS) criteria have effectively been applied (role for regulated third parties), and the risk assessment is also effectively completed (role and responsibility of investors).

But the present international and EU regulations are not allowing a revival of the securitisation market in Europe.

- Too many criteria for “Simple and Transparent and Standardised” to be checked by the institutional investors themselves without third party verifications, which are explicitly excluded by the current EU legislative proposal.
- Too heavy capital requirements for investors or banks to hold such assets on their books:

Two Examples:

Example 1: on junior tranches (BBB), the capital charge can go up, at this stage, to 19,7% per year of duration (Solvency 2 regulation).

Example 2: a seven year Credit Loan Obligation 3A carries a capital charge of 88%.

To make it short, this regime imposes around 3 to 4 times more capital charges than on a similar instrument but directly held.

A recent proposal from a rapporteur of the European Parliament suggests to resize the “skin in the game” rule from the current 5% introduced in the wake of the subprime crisis to 20%. This would deter EU banks from originating and would provoke the collapse of the securitization market

Let us not forget that the implementation of STS criteria is, by definition, going to improve the quality of the securitization process which, by the way, performed remarkably in Europe during the crisis.

If we want securitisation to take off, this calibration must be changed and favour a more pragmatic approach for attributing the various responsibilities and liabilities among the participants in the securitisation process. Members of the European Parliament should be in my view extremely vigilant on the regulation proposed by the EU Commission.

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Concluding remarks

More generally, our environment of low, or even negative, interest rates is not helping long term investment.

What would be, in a market economy, the future of long term investment projects that would involve high fixed costs and high risks ? who would finance them without an adequate remuneration ? More a project is risky and its profitability is uncertain, more the “actualization” rate must be high.

Resource allocation tends to lose its efficiency when interest rates get very low. Indeed the only projects that can be financed are the ones which are viable with very low rates. Less profitable and more risky investment (but perhaps socially more beneficial) would be left aside, since more profitable projects would absorb available resources (at low interest rates).

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The Juncker Plan is a welcome initiative. And its start is encouraging.

The key, in my view, of its success is to facilitate the transition from a bank’s balance sheet project model to an “investors model”. Indeed, with the Basel requirements, banks will not be able to hold substantial long term infrastructure projects on their balance sheets.

In order to fully achieve such aim, we really need “a new European long term capital market”. While there are many short term trading platforms for securities, there exists no long term capital market of a pan-European scale.

As has recently been suggested by David Harrison³, and in line with the proposals above on a special asset class for infrastructure investment, we need a market “designed for the purchase of securities to be held over the long term”. Indeed short term market volatility and fluctuations tend to discourage long term investment.

³ See *Law and Financial Markets Review – December 2014*.

Such an “insulation” of that type of long term investment from daily fluctuations, “would allow a better match of savings and productive investment on a pan-European basis”.

Imaginative solutions are called for and such proposals should be examined by the Commission⁴.

I would finally add that structural measures to promote pension funds and long term investment for retirement purposes are clearly called for in the Eurozone.

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⁴ See also the proposal of an investment fund in Europe that would mobilize short term savings and – through a guarantee mechanism – transform them into long term investment projects. Such an initiative would help bridge the gap between long term needs (South of Europe) and the supply of liquid savings (North).